

Accounting Units 1 & 2

Chapter 12 Reporting and managing inventory

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Chapter 12 Reporting and managing inventory — 12A Reporting for trading firms; Cost of Sales

Theory

A **trading business** earns its revenue by **buying inventory and reselling it** at a higher price — a bike shop, a hardware store, a wholesaler. This is the central difference from the **service business** of Unit 1, which sold its time and expertise and held **no inventory**. Because a trading business must give up the **cost** of the goods it sells in order to earn its sales revenue, its Income Statement looks different from a service business's in one important way: it reports a **Cost of Sales** and a **Gross Profit** before it lists its other expenses.

Why a trading business reports Cost of Sales and Gross Profit. When a service business earned a fee, nothing left the business except the time of its staff, which was already recorded as **Wages**. When a trading business makes a sale, two things happen at once: it earns **sales revenue**, and it gives up the **inventory** the customer takes away. The cost of that inventory — its **Cost of Sales** — is the single largest sacrifice the business makes to earn its sales, so it is reported **first**, immediately against sales, to reveal the **Gross Profit**: the profit made on the trading activity itself, before the running costs of the business are deducted.

- A **service business** moves in one step: **Net Profit = Total revenue – Total expenses**. It has **no Cost of Sales** and **no Gross Profit** line.
- A **trading business** inserts a **trading section** at the top of the Income Statement:

$$\text{Net Sales} - \text{Cost of Sales} = \text{Gross Profit}$$

and only then deducts its other operating expenses to reach Net Profit. (Those other expenses, and the full report to Net Profit, are the subject of section 12B; this section builds the trading section itself — Sales through to Gross Profit.)

Net Sales. The top line of the trading section is **Net Sales**, not simply Sales, because some customers return goods. **Sales** is the total selling price of all inventory sold during the period; **Sales Returns** is the selling price of goods customers returned. The revenue genuinely earned is:

$$\text{Net Sales} = \text{Sales} - \text{Sales Returns}$$

Cost of Sales. **Cost of Sales** is the total **cost price** of the inventory that has been sold — the cost the business gave up to make its sales. It is *not* the selling price and it is *not* the cost of everything purchased; it is only the cost of the units that actually **left as sales**. There are two ways to find it:

1. **From the inventory cards (perpetual).** In a perpetual system the cost of every sale is recorded on the inventory card as the goods go out (using FIFO or Identified Cost, as in Chapter 11). **Cost of Sales for the period is the total of those cost-of-sales amounts, net of any sales return brought back in.** Amounts that left the card for another reason — an **inventory loss**, **drawings** of inventory, or inventory **used for advertising** — are **not** part of Cost of Sales.
2. **By reconstruction (a periodic check).** When the cards are not given, Cost of Sales can be found from the movement in the inventory asset:

$$\begin{aligned} \text{Cost of goods available for sale} &= \text{Opening inventory} + \text{Purchases} - \text{Purchase Returns} \\ \text{Cost of Sales} &= \text{Cost of goods available for sale} - \text{Closing inventory} \end{aligned}$$

The reconstruction works cleanly only when the *only* reason inventory fell was **sales**. If some inventory was also **lost**, taken as **drawings** or used in **advertising**, those costs must be **subtracted separately**, because “available – closing” captures *every* reason inventory left, not just sales.

Gross Profit. Deducting Cost of Sales from Net Sales gives the **Gross Profit** — the profit on trading before other expenses:

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Sales}$$

Inventory losses and gains — the effect at this level. After Gross Profit, two inventory adjustments can change the result *before* the ordinary operating expenses are reached, giving an **Adjusted Gross Profit**:

- An **inventory loss** (a physical count *below* the recorded balance — through theft, breakage or spoilage) is **deducted** from Gross Profit. Under FIFO it is valued at the **oldest cost price on hand**.
- An **inventory gain** (a physical count *above* the recorded balance) is **added** to Gross Profit. Under FIFO it is valued at the **most recent cost price**.

$$\text{Adjusted Gross Profit} = \text{Gross Profit} - \text{Inventory loss} + \text{Inventory gain}$$

Each of these also changes the **Inventory** asset reported in the Balance Sheet: a loss reduces it, a gain increases it.

Units 3 & 4 preview. Units 3 & 4 add a third balance-day adjustment — an **inventory write-down** under the **lower of cost and net realisable value (NRV)** rule, made when the amount inventory could be sold for (net of any selling costs) has fallen below what it cost. It is beyond the Units 1 & 2 study design and is not assessed in the graded topic tests or practice examinations. In Units 1 & 2 inventory is reported at **cost**, adjusted only for the losses and gains a physical count reveals.

Ethical considerations. The Gross Profit is one of the first figures a **lender**, a prospective **buyer** or the **owner** looks at, because it shows whether the business is selling its inventory for enough to cover what the inventory cost. That makes it tempting to flatter. An owner might **fail to record an inventory loss** revealed by the physical count, **record an inventory gain the count did not support**, or **overstate the closing inventory** — each of which lifts the reported result (a higher closing inventory understates Cost of Sales, and an unrecorded loss or an invented gain leaves Adjusted Gross Profit too high). All three breach the owner's ethical duty to present a **faithful representation** — information that is **complete, free from material error** and **neutral (without bias)** — and destroy the **relevance** of the report for the decision it is meant to inform. A buyer who pays for the business on an inflated Gross Profit, or a bank that lends against it, is relying on trading results the business cannot in fact sustain, and the overstated Inventory asset will be exposed the moment the stock is counted or sold. Ethical reporting records the loss when the count reveals it, records a gain only when the count supports it, and values closing inventory honestly — so that Cost of Sales, Gross Profit and the Inventory asset all tell the truth.

Worked model. Ridgeline Cycles is a trading business that sells the *Summit* helmet and uses FIFO. Its inventory card for June 2025 is below. During June it made sales of \$3 000 (there were no sales returns), and a physical count on 30 June found **2 fewer helmets** than the card recorded — an inventory loss.

Inventory Card — Summit helmet (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Jun	Balance							20	30	600
5 Jun	Inv. 501	40	33	1320				20	30	600
								40	33	1320
12 Jun	Inv. S60				20	30	600	15	33	495
					25	33	825			
30 Jun	Memo 12 (loss)				2	33	66	13	33	429

The sale on 12 June draws first on the 20 helmets at \$30 (\$600), then on 25 of the helmets at \$33 (\$825), so the **Cost of Sales is \$600 + \$825 = \$1 425**. Because there were no sales returns, **Net Sales = Sales = \$3 000**, and **Gross Profit = \$3 000 – \$1 425 = \$1 575**. The inventory loss of 2 helmets is valued at the oldest cost on hand, \$33, = **\$66**, and is deducted from Gross Profit to give an **Adjusted Gross Profit of \$1 509**.

Income Statement (extract) for the month ended 30 June 2025

Ridgeline Cycles	\$	\$
Revenue		
Sales		3 000

Ridgeline Cycles	\$	\$
less Cost of Sales		(1 425)
Gross Profit		1 575
less Inventory loss		(66)
Adjusted Gross Profit		1 509

The same Cost of Sales can be confirmed by **reconstruction**, separating out the loss:

Ridgeline Cycles — Cost of Sales check	\$
Opening inventory (20 @ \$30)	600
add Purchases (40 @ \$33)	1 320
Cost of goods available for sale	1 920
less Closing inventory (13 @ \$33)	(429)
less Inventory loss (2 @ \$33)	(66)
Cost of Sales	1 425

Worked examples (scaffolded)

Example 1 — computing Cost of Sales from the card, with a sales return; contrasting a service business

Brightwater Supplies is a trading business that sells the *AquaPure* water filter and uses FIFO. During the month ended 31 July 2025 it sold 60 filters at \$40 each (Inv. S66) and a customer later returned 5 of them (Credit Note 15). Its inventory card is below. Prepare the trading section of the Income Statement down to Gross Profit, and explain how this differs from a service business's report.

Inventory Card — AquaPure filter (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Jul	Balance							30	20	600
6 Jul	Inv. 210	50	22	1100				30	20	600
								50	22	1100
15 Jul	Inv. S66				30	20	600	20	22	440
					30	22	660			
22 Jul	CN 15 (sales return)	5	22	110				25	22	550
Working					Comment					
Sales = 60 @ \$40 = \$2 400; Sales Returns = 5 @ \$40 = \$200. Net Sales = \$2 400 – \$200 = \$2 200 .					Net Sales is the selling price of the goods that were sold <i>and kept</i> by customers.					
Cost of the sale (15 July) = 30 @ \$20 + 30 @ \$22 = \$600 + \$660 = \$1 260.					FIFO assigns the oldest cost prices to the units sold; the sale spans two cost prices.					
less the sales return brought back in = 5 @ \$22 = \$110. Cost of Sales = \$1 260 – \$110 = \$1 150 .					The 5 returned filters go back on the card at the cost last taken out (\$22), so their cost is removed from Cost of Sales.					
Gross Profit = \$2 200 – \$1 150 = \$1 050 .					Net Sales less Cost of Sales — the profit on the trading activity itself.					

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
A service business would have no Cost of Sales and no Gross Profit — it holds no inventory, so it deducts its expenses directly from revenue.					The trading section (Net Sales → Gross Profit) exists only because inventory is bought and resold.					

Income Statement (extract) for the month ended 31 July 2025

Brightwater Supplies	\$	\$
Revenue		
Sales	2 400	
less Sales Returns	(200)	
Net Sales		2 200
less Cost of Sales		(1 150)
Gross Profit		1 050

Example 2 — the effect of an inventory loss at the Gross Profit level

Copperline Hardware sells the *Bolt box* (100-pack) and uses FIFO. During the month ended 31 August 2025 it sold 70 boxes at \$12 each (Inv. S80) — there were no sales returns. A physical count on 31 August found only 27 boxes on hand, 3 fewer than the card recorded (Memo 9). The card is below. Prepare the trading section down to Adjusted Gross Profit, and show the effect of the loss.

Inventory Card — Bolt box (100 pk) (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Aug	Balance							40	5	200
7 Aug	Inv. 310	60	6	360				40	5	200
								60	6	360
18 Aug	Inv. S80				40	5	200	30	6	180
					30	6	180			
31 Aug	Memo 9 (loss)				3	6	18	27	6	162
Working					Comment					
Net Sales = 70 @ \$12 = \$840 (no sales returns).					Sales equals Net Sales when nothing is returned.					
Cost of Sales = 40 @ \$5 + 30 @ \$6 = \$200 + \$180 = \$380 .					The oldest cost prices are assigned first; the loss is <i>not</i> part of Cost of Sales.					
Gross Profit = \$840 – \$380 = \$460 .					Trading profit before the inventory loss.					
Inventory loss = 3 @ \$6 (oldest cost on hand) = \$18 , deducted from Gross Profit.					A count <i>below</i> the card balance is a loss; under FIFO it is valued at the oldest cost still on hand.					
Adjusted Gross Profit = \$460 – \$18 = \$442 .					If the loss were ignored, the report would overstate the result by \$18 and overstate the Inventory asset by \$18.					

Income Statement (extract) for the month ended 31 August 2025

Copperline Hardware	\$	\$
Revenue		

Copperline Hardware	\$	\$
Sales		840
less Cost of Sales		(380)
Gross Profit		460
less Inventory loss		(18)
Adjusted Gross Profit		442

Worked examples (unscaffolded)

Example 3 — computing Cost of Sales by reconstruction

Meridian Office Supplies is a trading business. For the year ended 30 June 2025 its records show: opening inventory \$12 000; purchases of inventory \$85 000; purchase returns \$3 000; and closing inventory (per the 30 June count) \$15 000. Sales for the year were \$140 000 and sales returns \$5 000. No inventory was lost, taken as drawings or used for advertising. Prepare a schedule computing Cost of Sales, and the trading section of the Income Statement down to Gross Profit.

Net Purchases are $\$85\,000 - \$3\,000 = \$82\,000$, so the cost of goods available for sale is $\$12\,000 + \$82\,000 = \$94\,000$. Because the only reason inventory fell was sales, Cost of Sales is simply the available cost less the closing inventory: $\$94\,000 - \$15\,000 = \$79\,000$. Net Sales are $\$140\,000 - \$5\,000 = \$135\,000$.

Meridian Office Supplies — Cost of Sales	\$
Opening inventory	12 000
add Purchases	85 000
less Purchase Returns	(3 000)
Cost of goods available for sale	94 000
less Closing inventory	(15 000)
Cost of Sales	79 000

Income Statement (extract) for the year ended 30 June 2025

Meridian Office Supplies	\$	\$
Revenue		
Sales	140 000	
less Sales Returns	(5 000)	
Net Sales		135 000
less Cost of Sales		(79 000)
Gross Profit		56 000

∴ Meridian earned a Gross Profit of \$56 000 on its trading for the year.

Example 4 — an inventory gain and an inventory loss together

Harbourview Electronics reports for the month ended 30 September 2025. Sales were \$20 000 and sales returns \$800; Cost of Sales (from the inventory cards) was \$11 000. The physical count at balance day threw up an adjustment on **two** product lines: one line counted 3 units **more** than the card recorded — an **inventory gain of \$150** (valued at the latest cost price); the other counted 8 units **fewer** than the card recorded — an **inventory loss of \$400** (valued at the oldest cost on hand). Prepare the trading section down to Adjusted Gross Profit.

Net Sales are $\$20\,000 - \$800 = \$19\,200$, so Gross Profit is $\$19\,200 - \$11\,000 = \$8\,200$. The gain is **added** to Gross Profit and the loss is **deducted**: $\$8\,200 + \$150 - \$400 = \$7\,950$.

Income Statement (extract) for the month ended 30 September 2025

Revenue		
Sales	20 000	
less Sales Returns	(800)	
Net Sales		19 200
less Cost of Sales		(11 000)
Gross Profit		8 200
add Inventory gain		150
less Inventory loss		(400)
Adjusted Gross Profit		7 950

∴ after a \$150 gain on one line and a \$400 loss on another, the Adjusted Gross Profit is \$7 950. Both adjustments flow through to the **Inventory** asset in the Balance Sheet as well — the gain raises it by \$150 and the loss reduces it by \$400 — so the reports agree with what the physical count actually found on the shelves.

Practice questions — scaffolded

Question 1

Larkspur Homewares sells the *Ceramic vase* and uses FIFO. During the month ended 31 March 2025 it sold 40 vases at \$18 each (Inv. \$40); there were no sales returns. Its inventory card is below.

Inventory Card — Ceramic vase (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Mar	Balance							25	8	200
6 Mar	Inv. 120	35	10	350				25	8	200
								35	10	350
14 Mar	Inv. \$40				25	8	200	20	10	200
					15	10	150			

- State the Net Sales for March.
- Calculate the Cost of Sales for the sale on 14 March.
- Calculate the Gross Profit.

Question 2

Thornbury Traders provides the following for the year ended 30 June 2025: opening inventory \$9 000; purchases \$54 000; purchase returns \$2 000; closing inventory \$11 000; sales \$96 000; and sales returns \$4 000. No inventory was lost, taken as drawings or used for advertising.

- Calculate Net Purchases.
- Prepare a schedule computing the Cost of Sales.
- Calculate the Gross Profit.

Question 3

Eastgate Tools reports for the month ended 30 April 2025: Sales \$6 300; Sales Returns \$300; Cost of Sales (from the inventory cards) \$3 500. A physical count on 30 April revealed an inventory loss of \$120.

- Calculate the Gross Profit.

- b. Calculate the Adjusted Gross Profit.
- c. Explain, in one or two sentences, how the inventory loss is reported in the Income Statement and why it is not part of Cost of Sales.

Question 4

Fitzroy Prints is a trading business. For the month ended 31 May 2025 its Sales were \$10 000, Sales Returns \$400 and Cost of Sales \$5 600.

- a. Calculate the Net Sales.
- b. Calculate the Gross Profit.
- c. Explain the **two** report lines a trading business shows that a service business does not, and why a trading business needs them.

Question 5

Glenferrie Cellars reports for the month ended 30 June 2025: Net Sales \$14 000 and Cost of Sales \$8 500. The physical count at balance day found an inventory **gain of \$90** on one line and an inventory **loss of \$260** on another.

- a. Calculate the Gross Profit.
- b. Calculate the Adjusted Gross Profit.
- c. Explain why the gain is **added** to Gross Profit while the loss is **deducted**.

Question 6

Northcote Cycles reports Net Sales of \$18 000 and Cost of Sales of \$10 000 for the month ended 31 July 2025. The physical count at balance day found 12 bicycles fewer than the inventory cards recorded — an **inventory loss of \$1 500**. The owner, who is about to apply for a bank loan, proposes to **leave the loss out** of the report “because the bikes might still turn up”.

- a. Calculate the correct Gross Profit and the correct Adjusted Gross Profit.
- b. Calculate the “Gross Profit” the owner’s proposal would report, and state by how much it overstates the true result.
- c. Discuss the ethical considerations raised by the owner’s proposal, referring to a relevant qualitative characteristic and to the effect on the Balance Sheet.

Practice questions — unscaffolded

Question 7

Sandringham Sports sells the *Tennis racquet* and uses FIFO. During the month ended 31 July 2025 it sold 25 racquets at \$90 each (Inv. \$60); there were no sales returns. Its inventory card is below. Calculate the Cost of Sales and the Gross Profit, and prepare the trading section of the Income Statement down to Gross Profit.

Inventory Card — Tennis racquet (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Jul	Balance							8	40	320
5 Jul	Inv. 501	22	45	990				8	40	320
								22	45	990
19 Jul	Inv. S60				8	40	320	5	45	225
					17	45	765			

Question 8

Camberwell Wholesale provides the following for the year ended 30 June 2025: opening inventory \$20 000; purchases \$130 000; purchase returns \$6 000; closing inventory \$24 000; sales \$205 000; and sales returns \$5 000. Prepare a schedule computing Cost of Sales, and calculate the Gross Profit.

Question 9

Prahran Provisions sells *Olive oil (1 L)* and uses FIFO. During the month ended 31 August 2025 it sold 60 bottles at \$12 each (Inv. S70); there were no sales returns. A physical count on 31 August found 28 bottles on hand (Memo 6). Its card is below. Prepare the trading section down to Adjusted Gross Profit, and state the amount reported for **Inventory** in the Balance Sheet as at 31 August.

Inventory Card — Olive oil 1 L (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Aug	Balance							50	6	300
8 Aug	Inv. 410	40	7	280				50	6	300
								40	7	280
20 Aug	Inv. S70				50	6	300	30	7	210
					10	7	70			
31 Aug	Memo 6 (loss)				2	7	14	28	7	196

Question 10

Malvern Menswear sells the *Wool scarf* and uses FIFO. During the month ended 30 September 2025 it sold 35 scarves at \$45 each (Inv. S71), and a customer returned 3 of them (Credit Note 22). Its card is below. Calculate the Net Sales, the Cost of Sales and the Gross Profit.

Inventory Card — Wool scarf (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Sep	Balance							20	15	300
6 Sep	Inv. 505	30	18	540				20	15	300
								30	18	540
16 Sep	Inv. S71				20	15	300	15	18	270
					15	18	270			
23 Sep	CN 22 (sales return)	3	18	54				18	18	324

Question 11

Hawthorn Homewares reports for the month ended 31 October 2025: Sales \$9 800; Sales Returns \$300; Cost of Sales \$5 200. A physical count found an inventory gain of \$80. Calculate the Gross Profit and the Adjusted Gross Profit, and explain in one sentence why the gain is treated as it is.

Question 12

Kew Kitchenware reports Net Sales of \$40 000 and Cost of Sales of \$22 000 for the year ended 30 June 2025. Its inventory cards showed 220 *Copper pan sets* on hand at 30 June, all at a cost of \$40 each, but the physical count that day found only 200. Calculate the inventory loss and the Adjusted Gross Profit, state the amount reported for **Inventory** in the Balance Sheet, and explain why a physical count is needed at all, with reference to a relevant qualitative characteristic.

Question 13

Brunswick Books reports Net Sales of \$150 000 and a Gross Profit of \$60 000 for the year ended 30 June 2025. Its opening inventory was \$18 000 and its net purchases for the year were \$95 000; no inventory was lost, taken as drawings or used for advertising. Using the relationships between these figures, calculate the Cost of Sales and the closing inventory.

Question 14

Coburg Consulting is a service business and Coburg Cycles is a trading business. For the month ended 31 May 2025 Coburg Cycles had Net Sales of \$12 000 and Cost of Sales of \$7 000. Prepare the trading section of Coburg Cycles' Income Statement down to Gross Profit, then explain why only the trading business reports a Cost of Sales and a Gross Profit, and what the Gross Profit tells its owner that a service business's report cannot.

Question 15

Williamstown Marine sells the *Life ring* and uses FIFO. During the month ended 30 November 2025 it sold 30 rings at \$60 each (Inv. S80); a customer returned 2 of them (Credit Note 30); and a physical count on 30 November found 11 rings on hand (Memo 15). Its card is below. Prepare the trading section of the Income Statement down to Adjusted Gross Profit, and state the amount reported for **Inventory** in the Balance Sheet as at 30 November.

Inventory Card — Life ring (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Nov	Balance							12	25	300
5 Nov	Inv. 700	28	28	784				12	25	300
								28	28	784
14 Nov	Inv. S80				12	25	300	10	28	280
					18	28	504			
18 Nov	CN 30 (sales return)	2	28	56				12	28	336
30 Nov	Memo 15 (loss)				1	28	28	11	28	308

Question 16

Footscray Fasteners provides the following for the year ended 30 June 2025: opening inventory \$8 000; purchases \$50 000 (no purchase returns); closing inventory (per the count) \$9 500; and an inventory loss of \$500 recorded during the year (no drawings or advertising of inventory). Sales were \$85 000 with no sales returns. Calculate the Cost of Sales (taking care to separate the loss), then prepare the trading section down to Adjusted Gross Profit.

Question 17

Explain, for a trading business, what **Gross Profit** measures and why it is reported as a **separate subtotal** ahead of the other operating expenses, rather than lumping Cost of Sales in with them. Contrast this with the single-step Income Statement of a service business, and identify one decision the Gross Profit helps a trading owner make that a service owner's report does not support.

Question 18

Yarraville Traders is being prepared for sale. For the year ended 30 June 2025 its Net Sales were \$60 000 and its Cost of Sales, correctly calculated, \$36 000. A physical count on 30 June revealed an **inventory loss of \$2 400** (stock shrinkage). To present a stronger result to a prospective buyer, the owner proposes **two** changes: to record **no inventory loss** at all, and to leave in the closing inventory \$1 000 of goods that had already been **sold and were awaiting collection** by the customer — which would report Cost of Sales as \$35 000. Calculate the correct Gross Profit and Adjusted Gross Profit, and the Gross Profit and “Adjusted Gross Profit” the owner’s proposal would report. Discuss the ethical considerations, referring to relevant qualitative characteristics and to the effect on the buyer’s decision and on the Inventory reported in the Balance Sheet.

Answers

1.
 - a. Net Sales \$720 b. Cost of Sales \$350 c. Gross Profit \$370
2.
 - a. Net Purchases \$52 000 b. Cost of Sales \$50 000 c. Gross Profit \$42 000
3.
 - a. Gross Profit \$2 500 b. Adjusted Gross Profit \$2 380 c. See solutions
4.
 - a. Net Sales \$9 600 b. Gross Profit \$4 000 c. See solutions
5.
 - a. Gross Profit \$5 500 b. Adjusted Gross Profit \$5 330 c. See solutions
6.
 - a. Gross Profit \$8 000; Adjusted Gross Profit \$6 500 b. Reported “Gross Profit” \$8 000 — overstates the true result by \$1 500 c. See solutions
7. Cost of Sales \$1 085; Gross Profit \$1 165
8. Cost of Sales \$120 000; Gross Profit \$80 000
9. Gross Profit \$350; inventory loss \$14; Adjusted Gross Profit \$336; Inventory (Balance Sheet) \$196
10. Net Sales \$1 440; Cost of Sales \$516; Gross Profit \$924
11. Gross Profit \$4 300; Adjusted Gross Profit \$4 380
12. Inventory loss \$800; Adjusted Gross Profit \$17 200; Inventory (Balance Sheet) \$8 000
13. Cost of Sales \$90 000; closing inventory \$23 000
14. Gross Profit \$5 000; See solutions
15. Cost of Sales \$748; Gross Profit \$932; Adjusted Gross Profit \$904; Inventory (Balance Sheet) \$308
16. Cost of Sales \$48 000; Adjusted Gross Profit \$36 500
17. See solutions
18. Correct Gross Profit \$24 000; correct Adjusted Gross Profit \$21 600; reported Gross Profit \$25 000 and “Adjusted Gross Profit” \$25 000 — overstates by \$3 400

Fully-worked solutions

Question 1

- a. There were no sales returns, so **Net Sales = Sales = 40 @ \$18 = \$720**.
- b. The sale draws first on the 25 vases at \$8 (\$200), then on 15 of the vases at \$10 (\$150), so **Cost of Sales = \$200 + \$150 = \$350**.
- c. **Gross Profit = \$720 – \$350 = \$370**.

Income Statement (extract) for the month ended 31 March 2025

Larkspur Homewares	\$	\$
Revenue		
Sales		720
less Cost of Sales		(350)
Gross Profit		370

Question 2

- a. **Net Purchases = \$54 000 – \$2 000 = \$52 000**.
- b. Cost of goods available for sale = \$9 000 + \$52 000 = \$61 000; **Cost of Sales = \$61 000 – \$11 000 = \$50 000**.

Thornbury Traders — Cost of Sales	\$
Opening inventory	9 000

Thornbury Traders — Cost of Sales	\$
add Purchases	54 000
less Purchase Returns	(2 000)
Cost of goods available for sale	61 000
less Closing inventory	(11 000)
Cost of Sales	50 000

c. $\text{Net Sales} = \$96\,000 - \$4\,000 = \$92\,000$, so **Gross Profit** = $\$92\,000 - \$50\,000 = \$42\,000$.

Question 3

- Gross Profit** = $\text{Net Sales} - \text{Cost of Sales} = (\$6\,300 - \$300) - \$3\,500 = \$6\,000 - \$3\,500 = \$2\,500$.
- Adjusted Gross Profit** = $\$2\,500 - \$120 = \$2\,380$.
- The inventory loss is **deducted from Gross Profit** (to give the Adjusted Gross Profit) and also reduces the **Inventory** asset in the Balance Sheet. It is **not** part of Cost of Sales because Cost of Sales is only the cost of inventory that was **sold**; the lost units were not sold, so their cost is reported separately as an inventory loss.

Question 4

- Net Sales** = $\$10\,000 - \$400 = \$9\,600$.
- Gross Profit** = $\$9\,600 - \$5\,600 = \$4\,000$.
- A trading business shows a **Cost of Sales** and a **Gross Profit** that a service business does not. It needs them because it earns revenue by **buying and reselling inventory**: the cost of the inventory sold is the largest sacrifice made to earn its sales, so it is matched directly against Net Sales to reveal the **Gross Profit** — the profit on trading before other operating expenses. A service business holds **no inventory** (it sells its time and expertise), so there is no cost of goods to deduct and its Income Statement moves in a single step from revenue to Net Profit.

Question 5

- Gross Profit** = $\$14\,000 - \$8\,500 = \$5\,500$.
- Adjusted Gross Profit** = $\$5\,500 + \$90 - \$260 = \$5\,330$.
- The **gain** means the count found **more** inventory on hand than the card recorded — an increase in the Inventory asset and a benefit to the business — so it is **added** to Gross Profit. The **loss** means the count found **fewer** units than the card recorded — inventory has gone (through theft, breakage or spoilage) without earning any revenue, a decrease in the Inventory asset and a sacrifice — so it is **deducted** from Gross Profit.

Question 6

- Gross Profit** = $\$18\,000 - \$10\,000 = \$8\,000$. The count is \$1 500 short of the cards, so the correct **Adjusted Gross Profit** = $\$8\,000 - \$1\,500 = \$6\,500$.

Income Statement (extract) for the month ended 31 July 2025

Northcote Cycles	\$	\$
Revenue		
Net Sales		18 000
less Cost of Sales		(10 000)
Gross Profit		8 000
less Inventory loss		(1 500)
Adjusted Gross Profit		6 500

- Leaving out the loss would report an Adjusted Gross Profit equal to the Gross Profit of **\$8 000**, **overstating** the true result of \$6 500 by **\$1 500**.

- c. Omitting the loss breaches the owner's ethical duty to present a **faithful representation** — information that is **complete, free from material error and neutral (without bias)**. The 12 bicycles are simply not there: the count, not the card, is the evidence of what the business holds, so the \$1 500 must be recorded as an inventory loss. Leaving it out **overstates the Inventory asset by \$1 500** in the Balance Sheet and **overstates the Adjusted Gross Profit by \$1 500** in the Income Statement, and it is omitted precisely to flatter the figures the bank will read — so the reports are neither complete nor neutral. This destroys the **relevance** of the reports for the bank's lending decision: the bank would be assessing the loan against trading results and an asset the business does not have, and the overstatement would be exposed at the next count. The ethical course is to record the \$1 500 loss now and report the \$6 500 the business has genuinely earned.

Question 7

The sale of 25 racquets draws on 8 @ \$40 (\$320) and 17 @ \$45 (\$765), so **Cost of Sales = \$320 + \$765 = \$1 085**. There were no sales returns, so Net Sales = 25 @ \$90 = \$2 250, and **Gross Profit = \$2 250 – \$1 085 = \$1 165**.

Income Statement (extract) for the month ended 31 July 2025

Sandringham Sports	\$	\$
Revenue		
Sales		2 250
less Cost of Sales		(1 085)
Gross Profit		1 165

Question 8

Net Purchases = \$130 000 – \$6 000 = \$124 000; cost of goods available for sale = \$20 000 + \$124 000 = \$144 000; **Cost of Sales = \$144 000 – \$24 000 = \$120 000**.

Camberwell Wholesale — Cost of Sales	\$
Opening inventory	20 000
add Purchases	130 000
less Purchase Returns	(6 000)
Cost of goods available for sale	144 000
less Closing inventory	(24 000)
Cost of Sales	120 000

Net Sales = \$205 000 – \$5 000 = \$200 000, so **Gross Profit = \$200 000 – \$120 000 = \$80 000**.

Question 9

The sale of 60 bottles draws on 50 @ \$6 (\$300) and 10 @ \$7 (\$70), so **Cost of Sales = \$370**. Net Sales = 60 @ \$12 = \$720, so **Gross Profit = \$720 – \$370 = \$350**. The count of 28 against a recorded 30 is an **inventory loss of 2 @ \$7 (oldest cost on hand) = \$14**, so **Adjusted Gross Profit = \$350 – \$14 = \$336**.

Income Statement (extract) for the month ended 31 August 2025

Prahran Provisions	\$	\$
Revenue		
Sales		720
less Cost of Sales		(370)
Gross Profit		350
less Inventory loss		(14)
Adjusted Gross Profit		336

The closing balance on the card is 28 @ \$7 = \$196, so **Inventory in the Balance Sheet as at 31 August = \$196**.

Question 10

Net Sales = $(35 @ \$45) - (3 @ \$45) = \$1\,575 - \$135 = \$1\,440$. The sale of 35 scarves cost $20 @ \$15 (\$300) + 15 @ \$18 (\$270) = \$570$; the sales return brings $3 @ \$18 (\$54)$ back in, so **Cost of Sales** = $\$570 - \$54 = \$516$. **Gross Profit** = $\$1\,440 - \$516 = \$924$.

Income Statement (extract) for the month ended 30 September 2025

Malvern Menswear	\$	\$
Revenue		
Sales	1 575	
less Sales Returns	(135)	
Net Sales		1 440
less Cost of Sales		(516)
Gross Profit		924

Question 11

Net Sales = $\$9\,800 - \$300 = \$9\,500$, so **Gross Profit** = $\$9\,500 - \$5\,200 = \$4\,300$. The inventory gain of \$80 is **added: Adjusted Gross Profit** = $\$4\,300 + \$80 = \$4\,380$. The gain is added because the count found **more** inventory on hand than the card recorded — an increase in the Inventory asset — so it improves the result at the Gross Profit level.

Question 12

The cards recorded 220 sets but only 200 were found, so **20 sets are missing: the inventory loss** = $20 @ \$40 = \800 . Gross Profit = $\$40\,000 - \$22\,000 = \$18\,000$, so **Adjusted Gross Profit** = $\$18\,000 - \$800 = \$17\,200$. The Inventory reported in the Balance Sheet is what the count found: **200 @ \$40 = \$8 000** (not the \$8 800 the cards showed).

A **physical count** is needed because the inventory card records only what *should* be on hand — every unit that was bought less every unit recorded as leaving. It cannot record what leaves without being recorded: theft, breakage, spoilage or a simple recording error. Only counting the stock reveals what the business **actually** holds. Recording the \$800 difference as an inventory loss gives a **faithful representation** — the Inventory asset and the profit are then complete and free from material error, rather than showing \$800 of stock that does not exist — and keeps the reports **relevant** to the owner's decisions, because a loss of this size is a signal to review security and handling of the stock.

Question 13

Cost of Sales = Net Sales – Gross Profit = $\$150\,000 - \$60\,000 = \$90\,000$. Cost of goods available for sale = opening inventory + net purchases = $\$18\,000 + \$95\,000 = \$113\,000$, and since Cost of Sales = available – closing inventory (no other inventory movements), **closing inventory** = $\$113\,000 - \$90\,000 = \$23\,000$.

Question 14

Income Statement (extract) for the month ended 31 May 2025

Coburg Cycles	\$	\$
Revenue		
Net Sales		12 000
less Cost of Sales		(7 000)
Gross Profit		5 000

Only **Coburg Cycles** reports a Cost of Sales and a Gross Profit because it is a **trading business** — it earns revenue by buying inventory and reselling it, so it gives up the **cost of that inventory** (\$7 000) to earn its Net Sales (\$12 000). Matching the two reveals a **Gross Profit of \$5 000**: the profit on trading before other operating expenses. **Coburg Consulting**, a service business, holds **no inventory** — it sells its expertise — so there is no cost of goods to deduct and its report moves in a single step to Net Profit. The Gross Profit tells the trading owner whether the **mark-up** on

inventory is high enough to cover the cost of the goods (and leave something toward other expenses) — a check on buying and pricing decisions that a service owner's single-step report cannot provide.

Question 15

Net Sales = $(30 @ \$60) - (2 @ \$60) = \$1\,800 - \$120 = \$1\,680$. The sale of 30 rings cost $12 @ \$25 (\$300) + 18 @ \$28 (\$504) = \$804$; the sales return brings $2 @ \$28 (\$56)$ back in, so **Cost of Sales** = $\$804 - \$56 = \$748$. **Gross Profit** = $\$1\,680 - \$748 = \$932$. The count of 11 against a recorded 12 is an **inventory loss of 1 @ \$28 = \$28**, so **Adjusted Gross Profit** = $\$932 - \$28 = \$904$.

Income Statement (extract) for the month ended 30 November 2025

Williamstown Marine	\$	\$
Revenue		
Sales	1 800	
less Sales Returns	(120)	
Net Sales		1 680
less Cost of Sales		(748)
Gross Profit		932
less Inventory loss		(28)
Adjusted Gross Profit		904

The closing balance on the card is $11 @ \$28 = \308 , so **Inventory in the Balance Sheet as at 30 November = \$308**.

Question 16

Here inventory fell for **two** reasons — sales **and** a loss — so “available – closing” captures both and the loss must be separated out. Cost of goods available for sale = $\$8\,000 + \$50\,000 = \$58\,000$; available – closing = $\$58\,000 - \$9\,500 = \$48\,500$, which is Cost of Sales **plus** the \$500 loss. Therefore **Cost of Sales** = $\$48\,500 - \$500 = \$48\,000$. Net Sales = $\$85\,000$ (no returns), so **Gross Profit** = $\$85\,000 - \$48\,000 = \$37\,000$, and **Adjusted Gross Profit** = $\$37\,000 - \$500 = \$36\,500$.

Income Statement (extract) for the year ended 30 June 2025

Footscray Fasteners	\$	\$
Revenue		
Net Sales		85 000
less Cost of Sales		(48 000)
Gross Profit		37 000
less Inventory loss		(500)
Adjusted Gross Profit		36 500

Question 17

Gross Profit measures the profit a trading business makes on its **trading activity alone** — the difference between what it sold its inventory for (Net Sales) and what that inventory cost it (Cost of Sales) — **before** any of the other costs of running the business are deducted. It is reported as a **separate subtotal** because Cost of Sales behaves quite differently from the other expenses: it varies directly with the level of sales and with the prices the business pays and charges, so isolating it lets the owner see, at a glance, whether the **mark-up** on inventory is adequate. Lumping Cost of Sales in with wages, rent and advertising would hide that relationship. A **service business** has no inventory and therefore no Cost of Sales, so its Income Statement has no trading section and moves in a **single step** from total revenue to Net Profit. The Gross Profit supports decisions that a service owner's report cannot — for example, whether to **change selling prices or mark-up**, or to switch suppliers to reduce the cost of inventory — because those decisions turn on the gap between sales and the cost of goods sold, which only a trading business reports.

Question 18

Gross Profit = \$60 000 – \$36 000 = \$24 000, and deducting the loss the correct **Adjusted Gross Profit** = \$24 000 – \$2 400 = \$21 600. Under the owner’s proposal the overstated closing inventory reports Cost of Sales as \$35 000, so the reported **Gross Profit** = \$60 000 – \$35 000 = \$25 000, and with no loss deducted the reported “**Adjusted Gross Profit**” = \$25 000 — **overstating** the true result of \$21 600 by \$3 400.

Income Statement (extract) for the year ended 30 June 2025

Yarraville Traders	\$	\$
Revenue		
Net Sales		60 000
less Cost of Sales		(36 000)
Gross Profit		24 000
less Inventory loss		(2 400)
Adjusted Gross Profit		21 600

The two changes work on the report in different places but in the same direction. Counting goods that have already been **sold** as though they were still on hand **overstates the closing inventory by \$1 000**, which **understates Cost of Sales by \$1 000** and so lifts Gross Profit from \$24 000 to \$25 000; recording **no inventory loss** then leaves the \$2 400 shrinkage out of the report altogether. Together they overstate the result by **\$3 400** — and they overstate the **Inventory** current asset by exactly the same \$3 400 (\$1 000 of goods the business no longer owns, plus \$2 400 of stock that is missing).

Both changes breach the owner’s ethical duty to present a **faithful representation** — the reports would be neither **complete** (a real \$2 400 loss is left out) nor **free from material error** (\$1 000 of sold goods is counted as inventory) nor **neutral** (both changes are made precisely to make the business look better to a buyer). They also destroy the **relevance** of the reports for the buyer’s decision: a buyer valuing the business on a \$25 000 result, and on an Inventory asset overstated by \$3 400, would **overpay** for trading performance and stock the business does not truly have — and would discover the shortfall at the first count after settlement. The shrinkage has already occurred, and goods sold and awaiting collection belong to the customer, not the business. The ethical course is to record the \$2 400 loss, report Cost of Sales at its correct \$36 000, and present the genuine Adjusted Gross Profit of \$21 600, so the buyer can make an informed decision.

Chapter 12 Reporting and managing inventory — 12B The Cash Flow Statement and Income Statement for a trading firm

Theory

A **trading business** earns its revenue by **buying and selling inventory**, rather than by providing a service. This one difference reshapes its reports. Where a service business moves in a single step from total revenue to Net Profit, a trading business must first work out how much it cost to buy the goods it sold — so its **Income Statement** shows an extra profit measure, **Gross Profit**, and its **Cash Flow Statement** carries a large new operating flow: the **cash paid for inventory**. This section prepares both classified reports for a trading firm and draws out the single most important idea that connects them — the difference between the **cost of inventory sold** and the **cash paid for inventory**.

The classified Income Statement for a trading firm. The report is built in ordered stages, each with its own subtotal, so a reader can see *where* the profit is made:

- **1. Revenue → Net Sales.** The report opens with **Net Sales** — the revenue earned from selling inventory, after deducting any goods customers returned:

$$\text{Net Sales} = \text{Sales} - \text{Sales Returns}$$

- **2. less Cost of Sales → Gross Profit.** **Cost of Sales** is the **cost price of the inventory sold** during the period — the total of the **cost-of-sales amounts** recorded in the OUT column of the inventory cards, *net of any sales return brought back IN*. Inventory that left the card for another reason — an **inventory loss**, **drawings** of inventory, or inventory **used for advertising** — is **not** part of Cost of Sales. Deducting Cost of Sales from Net Sales gives **Gross Profit**, the profit made purely from buying and selling:

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Sales}$$

- **3. add Other Revenue.** Revenue earned **other than from selling inventory** — such as **Interest revenue** or **Rent revenue** — is **added after Gross Profit** (it is not part of Net Sales, because it does not come from trading inventory).
- **4. less Expenses → Net Profit.** The **other expenses** of running the business — **Wages**, **Rent expense**, **Advertising**, **Electricity**, **Interest expense** — are grouped under **Less Expenses**, subtotalled, and deducted to give the **Net Profit** (or, if expenses exceed the gross profit and other revenue, a **Net Loss**):

$$\text{Net Profit} = \text{Gross Profit} + \text{Other revenue} - \text{Total expenses}$$

Its title states the business, the report and the period: “**Income Statement for the <period> ended <date>**” — a *period* title, because profit is earned *over* a span of time.

The classified Cash Flow Statement for a trading firm. The Cash Flow Statement reports **cash only**, classified into the same three activities used for a service business:

- **Operating activities** — the cash effects of day-to-day trading: **cash sales** and **GST received** (inflows), and payments for **cash purchases of inventory**, **wages**, **rent**, **advertising**, **interest expense** and **GST paid** (outflows). **Buying inventory is an operating activity**, so the cash paid for inventory is an **operating outflow** — usually the largest one a trading firm has.
- **Investing activities** — cash spent acquiring, or received from selling, **non-current assets** (shop fittings, vehicles, equipment). A cash purchase of equipment is an investing **outflow**; the cash proceeds from selling an old asset are an investing **inflow**.
- **Financing activities** — cash from the owner and from lenders: **capital contributions** and **loans received** (inflows), and **drawings** and **loan (principal) repayments** (outflows).

Each activity is subtotalled — **Net cash from Operating activities**, **Net cash used in Investing activities**, **Net cash from Financing activities** — and the three re-sum to the **net increase or decrease in cash**, which is added to the opening **Bank** balance to give the closing balance. Outflows are shown in **brackets**; a negative closing balance is a **bank overdraft** (a current liability). As for a service business, **GST received** and **GST paid** are **Operating** flows, so a non-current asset in Investing is shown at its **GST-exclusive** cash cost, with its GST included in Operating GST paid.

The key distinction: cost of inventory sold vs cash paid for inventory. These two figures look similar and are easily confused, but they answer **different questions** and belong in **different reports**:

- **Cost of Sales** is the **cost of the inventory that was sold** this period. It is an **expense** in the **Income Statement**, deducted from Net Sales to find Gross Profit. It is **not a cash flow** — the cash for those goods may have been paid in an earlier period, and it never appears in the Cash Flow Statement.
- **Cash paid for inventory** is the **cash that actually left the Bank to buy inventory** this period. It is an **operating outflow** in the **Cash Flow Statement**. It is **not an expense** — buying inventory swaps one asset (Bank) for another (Inventory); only the portion later *sold* becomes Cost of Sales.

The two are equal only when a business buys **exactly** the quantity it sells. Whenever the amounts differ, the gap is the **change in the level of inventory on hand**:

Cash paid for inventory – Cost of Sales = increase (or decrease) in inventory

equivalently, **Purchases = Cost of Sales + (closing inventory – opening inventory)**

Both forms hold when **selling** is the only reason inventory leaves the cards; any inventory **lost**, taken as **drawings** or **used for advertising** must be allowed for separately, because it reduces the inventory on hand without ever becoming Cost of Sales. If a firm **buys more than it sells**, cash paid for inventory **exceeds** Cost of Sales and inventory **builds up**; if it **sells more than it buys** (running stock down), Cost of Sales **exceeds** cash paid for inventory. This is a leading reason a **profitable** trading firm can still be **short of cash**: profit is reduced only by the cost of what was *sold*, but the Bank is drained by the cash paid for *everything bought*. The closing inventory that results is neither an expense nor a cash flow — it is a **current asset** reported in the Balance Sheet.

Ethical considerations. Because both reports are read by outsiders — a **lender** assessing a loan, a prospective **buyer** valuing the business, the **owner** deciding whether to keep trading — the owner has an ethical duty to prepare them as a **faithful representation: complete, free from material error and neutral (without bias)**. In a trading business the temptations are specific. It would be misleading to **understate Cost of Sales** so that **Gross Profit looks stronger** than the trading truly delivered, or to move part of Cost of Sales **below the Gross Profit line** among the other expenses so the gross profit margin appears healthier to a buyer. It would equally be misleading to **classify a one-off capital contribution or loan receipt as though it were cash from operations**, disguising how much of the firm's cash actually comes from borrowing rather than from selling inventory. Such choices give users a false view of how well the business trades, may lead a lender or buyer to act on figures that cannot be sustained, and damage the owner's reputation once the true position emerges. Ethical reporting deducts the **true cost of the inventory sold**, classifies each cash flow **truthfully**, and lets the reader judge the business on its genuine gross profit and its genuine operating cash.

Worked model. Brookfield Traders sells homewares for cash and had a **Bank** balance of \$8 000 on 1 June 2025. During June it made **cash sales of \$60 000 (plus \$6 000 GST)**; its inventory cards showed a **Cost of Sales of \$34 000**; it made **cash purchases of inventory of \$40 000 (plus \$4 000 GST)**; and it paid **wages \$9 000, rent \$3 000 (plus \$300 GST), advertising \$1 200 (plus \$120 GST) and interest expense \$300**. It also paid **\$10 000 (plus \$1 000 GST)** for shop fittings, received a **\$5 000 capital contribution** and a **\$12 000 loan from MetroBank**, and paid **\$4 000 drawings** and a **\$1 000 loan repayment**. There were no sales returns this month, so **Net Sales = Sales = \$60 000**.

Gross Profit is \$60 000 – \$34 000 = **\$26 000**, and after expenses of \$9 000 + \$3 000 + \$1 200 + \$300 = \$13 500 the Net Profit is **\$12 500**. Notice the **Cost of Sales of \$34 000** (Income Statement) differs from the **cash purchases of inventory of \$40 000** (Cash Flow Statement): the firm **bought \$6 000 more inventory than it sold**, so its inventory on hand **rose by \$6 000** — a difference that appears in neither the Gross Profit nor the operating cash as an expense, but as a larger Inventory asset.

Income Statement for the month ended 30 June 2025

Brookfield Traders	\$	\$
Revenue		
Cash Sales	60 000	
Net Sales		60 000
less Cost of Sales		(34 000)

Brookfield Traders	\$	\$
Gross Profit		26 000
less Expenses		
Wages	9 000	
Rent expense	3 000	
Advertising	1 200	
Interest expense	300	
Total expenses		(13 500)
Net Profit		12 500

Cash Flow Statement for the month ended 30 June 2025

Brookfield Traders	\$	\$
Operating activities		
Cash sales	60 000	
GST received	6 000	
Cash purchases of inventory	(40 000)	
Wages	(9 000)	
Rent expense	(3 000)	
Advertising	(1 200)	
Interest expense	(300)	
GST paid	(5 420)	
Net cash from Operating activities		7 080
Investing activities		
Purchase of shop fittings	(10 000)	
Net cash used in Investing activities		(10 000)
Financing activities		
Capital contribution	5 000	
Loan – MetroBank	12 000	
Drawings	(4 000)	
Loan repayment	(1 000)	
Net cash from Financing activities		12 000
Net increase in cash		9 080
Add: Bank balance at start (1 June)		8 000
Bank balance at end (30 June)		17 080

(GST paid = \$4 000 on inventory + \$300 on rent + \$120 on advertising + \$1 000 on the shop fittings = **\$5 420**; the net GST position is \$6 000 – \$5 420 = **\$580 payable** to the ATO.)

Worked examples (scaffolded)

Example 1 — preparing a classified Income Statement for a trading firm

Riverbend Homewares provides the following for the month ended 31 July 2025: Sales \$84 000; Sales Returns \$4 000; Cost of Sales \$46 000; Interest revenue \$400; Wages \$12 000; Rent expense \$4 000; Advertising \$1 500; Electricity \$600; and Interest expense \$300. Prepare the classified Income Statement.

Working	Comment
Net Sales = Sales \$84 000 – Sales Returns \$4 000 = \$80 000 .	The report begins with the revenue left after goods returned by customers are deducted.
Gross Profit = Net Sales \$80 000 – Cost of Sales \$46 000 = \$34 000 .	Cost of Sales (the cost of the units sold) is deducted from Net Sales — this is the profit from trading alone.
add Interest revenue \$400 after Gross Profit → running total \$34 400.	Interest is earned on the Bank, not from selling inventory, so it is added <i>after</i> Gross Profit, not inside Net Sales.
Total expenses = \$12 000 + \$4 000 + \$1 500 + \$600 + \$300 = \$18 400 .	The other costs of operating are grouped and subtotalled.
Net Profit = \$34 000 + \$400 – \$18 400 = \$16 000 .	Gross Profit plus other revenue less total expenses.

Income Statement for the month ended 31 July 2025

Riverbend Homewares	\$	\$
Revenue		
Sales	84 000	
less Sales Returns	(4 000)	
Net Sales		80 000
less Cost of Sales		(46 000)
Gross Profit		34 000
add Other Revenue		
Interest revenue	400	
Total other revenue		400
less Expenses		
Wages	12 000	
Rent expense	4 000	
Advertising	1 500	
Electricity	600	
Interest expense	300	
Total expenses		(18 400)
Net Profit		16 000

Example 2 — the classified Cash Flow Statement, and the cost-of-sales / cash-paid distinction

Tallowwood Hardware had a **Bank** balance of \$6 000 on 1 August 2025. During August it made **cash sales of \$70 000 (plus \$7 000 GST)**; its inventory cards showed a **Cost of Sales of \$38 000**; it made **cash purchases of inventory of \$45 000 (plus \$4 500 GST)**; and it paid **wages \$10 000, rent \$3 500 (plus \$350 GST), advertising \$900 (plus \$90 GST) and interest expense \$250**. It also paid **\$20 000 (plus \$2 000 GST)** for a delivery van, received an **\$8 000 capital contribution** and a **\$10 000 loan from Coastal Bank**, and paid **\$3 000 drawings** and a **\$1 200 loan repayment**. Inventory on hand was \$9 000 at 1 August and \$16 000 at 31 August. Prepare the Cash Flow Statement and explain the difference between Cost of Sales and the cash paid for inventory.

Working	Comment
Operating in: Cash sales \$70 000 + GST received \$7 000 = \$77 000.	Day-to-day trading inflows.
GST paid = \$4 500 (inventory) + \$350 (rent) + \$90	GST on every cash purchase and expense, <i>including</i> the

Working	Comment
(advertising) + \$2 000 (van) = \$6 940 .	van, is an Operating outflow.
Operating out: \$45 000 + \$10 000 + \$3 500 + \$900 + \$250 + \$6 940 = \$66 590. → Net Operating = \$77 000 – \$66 590 = \$10 410 .	Cash purchases of inventory is the largest operating outflow.
Investing: Purchase of delivery van (\$20 000) — the GST-exclusive cost.	The \$2 000 GST sits in Operating GST paid; Investing shows only the \$20 000 asset cost.
Financing: Capital \$8 000 + Loan \$10 000 – Drawings \$3 000 – Loan repayment \$1 200 = \$13 800 .	Flows with the owner and the lender (loan principal only).
Net change = \$10 410 – \$20 000 + \$13 800 = \$4 210 ; closing Bank = \$6 000 + \$4 210 = \$10 210 .	The three activities re-sum to the net change in cash.
Distinction: cash purchases of inventory \$45 000 vs Cost of Sales \$38 000 → bought \$7 000 more than sold, so inventory rose \$9 000 → \$16 000.	Cost of Sales (\$38 000) is the Income-Statement expense; the \$45 000 cash paid is the Cash-Flow outflow; the \$7 000 gap is the extra Inventory asset.

Cash Flow Statement for the month ended 31 August 2025

Tallowood Hardware	\$	\$
Operating activities		
Cash sales	70 000	
GST received	7 000	
Cash purchases of inventory	(45 000)	
Wages	(10 000)	
Rent expense	(3 500)	
Advertising	(900)	
Interest expense	(250)	
GST paid	(6 940)	
Net cash from Operating activities		10 410
Investing activities		
Purchase of delivery van	(20 000)	
Net cash used in Investing activities		(20 000)
Financing activities		
Capital contribution	8 000	
Loan – Coastal Bank	10 000	
Drawings	(3 000)	
Loan repayment	(1 200)	
Net cash from Financing activities		13 800
Net increase in cash		4 210
Add: Bank balance at start (1 August)		6 000
Bank balance at end (31 August)		10 210

The **Cost of Sales of \$38 000** appears **only** in the Income Statement, as the expense of the goods sold; the **\$45 000 cash paid for inventory** appears **only** in the Cash Flow Statement, as an operating outflow. They differ by \$7 000 because the business bought more than it sold, lifting inventory on hand from \$9 000 to \$16 000.

Worked examples (unscaffolded)

Example 3 — a classified Income Statement

Greenslade Cycles provides the following for the month ended 30 September 2025: Sales \$52 000; Sales Returns \$2 000; Cost of Sales \$30 000; Wages \$8 000; Rent expense \$3 000; Advertising \$700; Electricity \$500; and Interest expense \$300. Prepare the classified Income Statement.

Net Sales = \$52 000 – \$2 000 = \$50 000; Gross Profit = \$50 000 – \$30 000 = \$20 000; total expenses = \$8 000 + \$3 000 + \$700 + \$500 + \$300 = \$12 500; Net Profit = \$20 000 – \$12 500 = \$7 500.

Income Statement for the month ended 30 September 2025

Greenslade Cycles	\$	\$
Revenue		
Sales	52 000	
less Sales Returns	(2 000)	
Net Sales		50 000
less Cost of Sales		(30 000)
Gross Profit		20 000
less Expenses		
Wages	8 000	
Rent expense	3 000	
Advertising	700	
Electricity	500	
Interest expense	300	
Total expenses		(12 500)
Net Profit		7 500

∴ Greenslade Cycles earned a Gross Profit of \$20 000 and a Net Profit of \$7 500 for September.

Example 4 — both reports for one trading firm, and why Net Profit is not the change in cash

Marlowe Sports had a **Bank** balance of \$4 000 on 1 October 2025 and made all sales and purchases for cash. During October it made **cash sales of \$48 000 (plus \$4 800 GST)**; its inventory cards showed a **Cost of Sales of \$26 000**; it made **cash purchases of inventory of \$22 000 (plus \$2 200 GST)**; and it paid **wages \$7 000, rent \$2 500 (plus \$250 GST), advertising \$600 (plus \$60 GST) and interest expense \$150**. It also paid **\$5 000 (plus \$500 GST)** for shop equipment, received a **\$3 000 capital contribution**, and paid **\$2 000 drawings** and an **\$800 loan repayment**. Inventory on hand fell from \$10 000 to \$6 000. Prepare both reports and explain why the Net Profit differs from the net increase in cash.

Income Statement: Net Sales \$48 000 (no returns) – Cost of Sales \$26 000 = Gross Profit \$22 000; total expenses \$7 000 + \$2 500 + \$600 + \$150 = \$10 250; Net Profit = **\$11 750**. Cash Flow Statement: GST paid = \$2 200 + \$250 + \$60 + \$500 = \$3 010; Net Operating = (\$48 000 + \$4 800) – (\$22 000 + \$7 000 + \$2 500 + \$600 + \$150 + \$3 010) = \$52 800 – \$35 260 = \$17 540; Net Investing = (\$5 000); Net Financing = \$3 000 – \$2 000 – \$800 = \$200; net increase = \$12 740; closing Bank = **\$16 740**.

Income Statement for the month ended 31 October 2025

Marlowe Sports	\$	\$
Revenue		

Marlowe Sports	\$	\$
Cash Sales	48 000	
Net Sales		48 000
less Cost of Sales		(26 000)
Gross Profit		22 000
less Expenses		
Wages	7 000	
Rent expense	2 500	
Advertising	600	
Interest expense	150	
Total expenses		(10 250)
Net Profit		11 750

Cash Flow Statement for the month ended 31 October 2025

Marlowe Sports	\$	\$
Operating activities		
Cash sales	48 000	
GST received	4 800	
Cash purchases of inventory	(22 000)	
Wages	(7 000)	
Rent expense	(2 500)	
Advertising	(600)	
Interest expense	(150)	
GST paid	(3 010)	
Net cash from Operating activities		17 540
Investing activities		
Purchase of shop equipment	(5 000)	
Net cash used in Investing activities		(5 000)
Financing activities		
Capital contribution	3 000	
Drawings	(2 000)	
Loan repayment	(800)	
Net cash from Financing activities		200
Net increase in cash		12 740
Add: Bank balance at start (1 October)		4 000
Bank balance at end (31 October)		16 740

∴ the Net Profit of \$11 750 is **not** the same as the \$12 740 increase in cash. The clearest reason is the inventory flows: the Income Statement is charged with the **\$26 000 Cost of Sales** (the goods sold), while the Bank was reduced by only the **\$22 000 cash purchases of inventory** (the goods bought) — the firm **sold \$4 000 more than it bought**, running

its inventory down from \$10 000 to \$6 000. On top of that, several **cash flows are neither revenue nor expenses** (the \$3 000 capital in, the \$2 000 drawings and \$800 loan repayment out, and the \$5 000 equipment purchase), and the \$4 800 GST received and \$3 010 GST paid move cash without affecting profit. Net Profit answers *how well the firm traded*; the change in Bank answers *how the cash balance moved*.

Practice questions — scaffolded

Question 1

Ferngully Furniture provides the following for the month ended 31 May 2025: Sales \$68 000; Sales Returns \$3 000; Cost of Sales \$40 000; Wages \$9 500; Rent expense \$3 200; Advertising \$800; and Electricity \$500.

- Prepare the classified Income Statement for the month ended 31 May 2025.
- State the Gross Profit and the Net Profit.
- Explain in one sentence what the Gross Profit tells the owner that the Net Profit does not.

Question 2

Brightwater Pools had a Bank balance of \$5 000 on 1 June 2025. June's cash flows were: cash sales \$40 000 plus \$4 000 GST; cash purchases of inventory \$24 000 plus \$2 400 GST; wages \$6 000; rent \$2 000 plus \$200 GST; advertising \$500 plus \$50 GST; the cash purchase of equipment \$8 000 plus \$800 GST; a capital contribution of \$6 000; a loan of \$5 000 from MetroBank; and drawings \$2 500.

- Classify each cash flow as an Operating, Investing or Financing activity.
- Calculate the net cash flow from Operating activities.
- Prepare the classified Cash Flow Statement for the month ended 30 June 2025.

Question 3

During July, Oakhaven Tiles made cash purchases of inventory of \$36 000 (plus GST) and its inventory cards showed a Cost of Sales of \$31 000. Inventory on hand was \$12 000 on 1 July and \$17 000 on 31 July.

- State which of the two figures — the \$36 000 or the \$31 000 — is reported in the Income Statement, and which is reported in the Cash Flow Statement.
- Calculate the increase in inventory on hand during July.
- Explain in one sentence why the cash paid for inventory differs from the Cost of Sales.

Question 4

Sunhaven Nursery provides the following for the month ended 31 August 2025: Sales \$58 000; Sales Returns \$3 000; Cost of Sales \$33 000; Interest revenue \$300; Wages \$8 500; Rent expense \$2 800; Advertising \$700; Electricity \$400; and Interest expense \$200.

- Prepare the classified Income Statement for the month ended 31 August 2025.
- State the Gross Profit and the Net Profit.
- Explain in one sentence why the interest revenue is added after Gross Profit rather than included in Net Sales.

Question 5

Copperleaf Kitchens had a Bank balance of \$3 500 on 1 September 2025. September's cash flows were: cash sales \$46 000 plus \$4 600 GST; cash purchases of inventory \$28 000 plus \$2 800 GST; wages \$7 500; rent \$2 400 plus \$240 GST; advertising \$600 plus \$60 GST; interest expense \$180; the cash purchase of a vehicle \$12 000 plus \$1 200 GST; a capital contribution of \$4 000; a loan of \$6 000 from Riverbank; drawings \$2 000; and a loan repayment of \$700.

- Prepare the classified Cash Flow Statement for the month ended 30 September 2025.
- Show that the closing Bank balance equals the opening balance plus the net change in cash.

- c. The bookkeeper classified the cash purchases of inventory as an Investing outflow. State the correct classification and explain in one sentence why it belongs there.

Question 6

Highfield Trading provides the following for the month ended 31 October 2025: Sales \$50 000 (no returns); Cost of Sales \$32 000; Wages \$7 000; Rent expense \$2 500; and Advertising \$500. To make the business look more profitable to a prospective buyer, the owner proposes to report only \$28 000 of the Cost of Sales above the Gross Profit line and to include the remaining \$4 000 among the other expenses instead.

- Prepare the **correct** classified Income Statement and state the Gross Profit and Net Profit.
- Calculate the “Gross Profit” that would be reported under the owner’s proposal.
- Discuss the ethical considerations raised by the owner’s proposal, referring to a relevant qualitative characteristic.

Practice questions — unscaffolded

Question 7

Meadowlark Bakery Supplies provides the following for the month ended 30 November 2025: Sales \$76 000; Sales Returns \$4 000; Cost of Sales \$44 000; Wages \$11 000; Rent expense \$3 500; Advertising \$900; Electricity \$600; and Interest expense \$400. Prepare the classified Income Statement and state the Net Sales, Gross Profit and Net Profit.

Question 8

Stormont Electrical Wholesale had a Bank balance of \$7 000 on 1 December 2025. December’s cash flows were: cash sales \$64 000 plus \$6 400 GST; cash purchases of inventory \$40 000 plus \$4 000 GST; wages \$9 000; rent \$3 000 plus \$300 GST; advertising \$800 plus \$80 GST; interest expense \$350; the cash purchase of a forklift \$15 000 plus \$1 500 GST; a capital contribution of \$5 000; a loan of \$8 000 from CityBank; drawings \$3 500; and a loan repayment of \$1 000. Prepare the classified Cash Flow Statement for the month ended 31 December 2025 and confirm the closing Bank balance.

Question 9

Ashgrove Timber & Tools had a Bank balance of \$6 500 on 1 January 2026 and made all sales and purchases for cash. January’s data were: cash sales \$90 000 plus \$9 000 GST; Cost of Sales \$52 000; cash purchases of inventory \$58 000 plus \$5 800 GST; wages \$14 000; rent \$4 000 plus \$400 GST; advertising \$1 200 plus \$120 GST; interest expense \$500; the cash purchase of equipment \$10 000 plus \$1 000 GST; a capital contribution of \$6 000; a loan of \$12 000 from Bayside Finance; drawings \$5 000; and a loan repayment of \$1 500. Prepare **both** the classified Income Statement and the classified Cash Flow Statement for January, and explain why the Net Profit differs from the net increase in cash.

Question 10

Delacroix Interiors reviews three months of inventory data. In each month it bought and sold inventory for cash; the cash purchases of inventory (ex-GST) and the Cost of Sales were: **Month 1** — purchases \$30 000, Cost of Sales \$25 000; **Month 2** — purchases \$22 000, Cost of Sales \$28 000; **Month 3** — purchases \$26 000, Cost of Sales \$26 000. For each month, state the change in inventory on hand and whether inventory rose, fell or was unchanged, then state the general relationship between purchases, Cost of Sales and the change in inventory.

Question 11

Fairhaven Trading is preparing its reports. For each item below, state whether it appears in the **Income Statement**, the **Cash Flow Statement**, **both** reports, or **neither**, and — for any Cash Flow Statement item — its activity (Operating, Investing or Financing): (i) Cost of Sales; (ii) cash purchases of inventory; (iii) cash sales; (iv) Sales Returns; (v) the cash purchase of a delivery van; (vi) a capital contribution; (vii) wages paid; (viii) drawings; (ix) closing inventory; (x) interest expense paid; (xi) GST paid to the ATO; (xii) a loan repayment.

Question 12

Willowmere Garden Centre provides the following for the month ended 28 February 2026: Sales \$96 000; Sales Returns \$6 000; Cost of Sales \$55 000; Interest revenue \$500; Rent revenue \$400; Wages \$13 500; Rent expense \$4 200; Advertising \$1 100; Electricity \$700; and Interest expense \$500. Prepare the classified Income Statement and state the Gross Profit and Net Profit.

Question 13

Redcliff Marine Supplies had a Bank balance of \$4 000 on 1 March 2026. March's cash flows were: cash sales \$38 000 plus \$3 800 GST; cash purchases of inventory \$20 000 plus \$2 000 GST; wages \$6 500; rent \$2 200 plus \$220 GST; advertising \$500 plus \$50 GST; interest expense \$200; the cash purchase of new equipment \$14 000 plus \$1 400 GST; cash proceeds from selling old equipment \$3 000 plus \$300 GST; drawings \$2 500; and a loan repayment of \$1 000. Prepare the classified Cash Flow Statement for the month ended 31 March 2026, determine the net GST position, and interpret the business's closing cash position.

Question 14

For the year ended 30 June 2026, Thornbury Trading reported a Cost of Sales of \$120 000. Its inventory on hand was \$15 000 at the start of the year and \$21 000 at the end, and all inventory was purchased for cash. Using account reconstruction, calculate the cost of the inventory **purchased** during the year and the cash paid for inventory (both excluding and including 10% GST), and state the report in which the Cost of Sales, the cash paid for inventory and the closing inventory are each reported.

Question 15

Glenhaven Outdoor Living provides the following for the month ended 30 April 2026: Sales \$44 000; Sales Returns \$3 000; Cost of Sales \$28 000; Wages \$9 000; Rent expense \$3 000; Advertising \$900; Electricity \$600; and Interest expense \$500. Prepare the classified Income Statement, state the result, and explain in one sentence what it tells the owner about the month's trading.

Question 16

Marchmont Traders reported a healthy Net Profit of \$40 000 for the year, yet its Bank balance **fell** over the same period. Its Cost of Sales was \$200 000 while its cash purchases of inventory were \$240 000; it also paid large drawings, repaid a loan and bought a new vehicle for cash. Explain how a **profitable** trading firm can still be short of cash, referring specifically to the distinction between Cost of Sales and cash paid for inventory, and give at least two other reasons a firm's cash can fall while it is making a profit.

Question 17

Explain, with reference to a relevant accounting assumption and a relevant qualitative characteristic, why the Income Statement reports the **Cost of Sales** (the cost of the inventory sold) as the expense of the period, rather than the **cash paid for inventory** during the period.

Question 18

Kingfisher Trading Co had a Bank balance of \$9 000 on 1 May 2026 and made all sales and purchases for cash. May's data were: cash sales \$110 000 plus \$11 000 GST; Cost of Sales \$60 000; cash purchases of inventory \$66 000 plus \$6 600 GST; interest revenue \$600; wages \$18 000; rent \$5 000 plus \$500 GST; advertising \$1 500 plus \$150 GST; interest expense \$700; the cash purchase of shop fittings \$12 000 plus \$1 200 GST; a capital contribution of \$10 000; a loan of \$15 000 from Coastal Bank; drawings \$6 000; and a loan repayment of \$2 000. Inventory on hand rose from \$14 000 to \$20 000. Prepare **both** the classified Income Statement and the classified Cash Flow Statement for May; state the Gross Profit, Net Profit, closing Bank balance and net GST position; and explain why the Net Profit differs from the net increase in cash.

Answers

1.
 - b. Gross Profit \$25 000; Net Profit \$11 000
2.
 - b. Net Operating \$8 050 (net Investing (\$8 000), net Financing \$8 500; closing Bank \$13 550)
3.
 - a. \$31 000 (Income Statement); \$36 000 (Cash Flow Statement) b. Increase of \$5 000
4.
 - b. Gross Profit \$22 000; Net Profit \$9 700
5. Net Operating \$7 620; net Investing (\$12 000); net Financing \$7 300; closing Bank \$6 420 c. Operating
6.
 - a. Gross Profit \$18 000; Net Profit \$8 000 b. Overstated “Gross Profit” \$22 000 (overstated by \$4 000)
7. Net Sales \$72 000; Gross Profit \$28 000; Net Profit \$11 600
8. Net Operating \$11 370; net Investing (\$15 000); net Financing \$8 500; closing Bank \$11 870
9. Net Profit \$18 300; net increase in cash \$15 480; closing Bank \$21 980
10. Month 1 +\$5 000 (rose); Month 2 −\$6 000 (fell); Month 3 nil (unchanged)
11. See solutions (classification key)
12. Net Sales \$90 000; Gross Profit \$35 000; Net Profit \$15 900
13. Net Operating \$9 030; net Investing (\$11 000); net Financing (\$3 500); closing Bank (\$1 470) — a bank overdraft; GST \$430 payable
14. Purchases \$126 000 (ex-GST); cash paid \$138 600 incl. GST; Cost of Sales \$120 000
15. Gross Profit \$13 000; Net **Loss** \$1 000
16. See solutions
17. See solutions
18. Gross Profit \$50 000; Net Profit \$25 400; net increase in cash \$26 950; closing Bank \$35 950; GST \$2 550 payable

Fully-worked solutions

Question 1

Net Sales = \$68 000 − \$3 000 = \$65 000; Gross Profit = \$65 000 − \$40 000 = \$25 000; total expenses = \$9 500 + \$3 200 + \$800 + \$500 = \$14 000; Net Profit = \$25 000 − \$14 000 = \$11 000.

Income Statement for the month ended 31 May 2025

Ferngully Furniture	\$	\$
Revenue		
Sales	68 000	
less Sales Returns	(3 000)	
Net Sales		65 000
less Cost of Sales		(40 000)
Gross Profit		25 000
less Expenses		
Wages	9 500	
Rent expense	3 200	
Advertising	800	
Electricity	500	
Total expenses		(14 000)
Net Profit		11 000

- b. Gross Profit = **\$25 000**; Net Profit = **\$11 000**.
- c. The **Gross Profit** shows the profit made from **buying and selling inventory alone** (Net Sales less Cost of Sales), whereas the **Net Profit** shows what is left **after all the other expenses** of running the business — so Gross Profit isolates how well the trading itself performed.

Question 2

- a. Cash sales, GST received, cash purchases of inventory, wages, rent, advertising and GST paid are **Operating**; the purchase of equipment is **Investing**; the capital contribution, the loan and drawings are **Financing**.
- b. GST paid = \$2 400 + \$200 + \$50 + \$800 = \$3 450. Net Operating = (\$40 000 + \$4 000) – (\$24 000 + \$6 000 + \$2 000 + \$500 + \$3 450) = \$44 000 – \$35 950 = **\$8 050**.

Cash Flow Statement for the month ended 30 June 2025

Brightwater Pools	\$	\$
Operating activities		
Cash sales	40 000	
GST received	4 000	
Cash purchases of inventory	(24 000)	
Wages	(6 000)	
Rent expense	(2 000)	
Advertising	(500)	
GST paid	(3 450)	
Net cash from Operating activities		8 050
Investing activities		
Purchase of equipment	(8 000)	
Net cash used in Investing activities		(8 000)
Financing activities		
Capital contribution	6 000	
Loan – MetroBank	5 000	
Drawings	(2 500)	
Net cash from Financing activities		8 500
Net increase in cash		8 550
Add: Bank balance at start (1 June)		5 000
Bank balance at end (30 June)		13 550

Question 3

- a. The **\$31 000 Cost of Sales** is reported in the **Income Statement** (as an expense, deducted from Net Sales to find Gross Profit); the **\$36 000 cash purchases of inventory** is reported in the **Cash Flow Statement** (an Operating outflow).
- b. Increase in inventory = closing – opening = \$17 000 – \$12 000 = **\$5 000** — equal to purchases \$36 000 – Cost of Sales \$31 000.

- c. The cash paid buys **all** the inventory purchased in July (\$36 000), whereas Cost of Sales counts only the inventory **sold** (\$31 000); the business bought \$5 000 more than it sold, so the extra inventory remains on hand as an asset rather than becoming an expense.

Question 4

Net Sales = \$58 000 – \$3 000 = \$55 000; Gross Profit = \$55 000 – \$33 000 = \$22 000; total expenses = \$8 500 + \$2 800 + \$700 + \$400 + \$200 = \$12 600; Net Profit = \$22 000 + \$300 – \$12 600 = \$9 700.

Income Statement for the month ended 31 August 2025

Sunhaven Nursery	\$	\$
Revenue		
Sales	58 000	
less Sales Returns	(3 000)	
Net Sales		55 000
less Cost of Sales		(33 000)
Gross Profit		22 000
add Other Revenue		
Interest revenue	300	
Total other revenue		300
less Expenses		
Wages	8 500	
Rent expense	2 800	
Advertising	700	
Electricity	400	
Interest expense	200	
Total expenses		(12 600)
Net Profit		9 700

- b. Gross Profit = **\$22 000**; Net Profit = **\$9 700**.

- c. Interest revenue is **not earned from selling inventory** — it is earned on the Bank — so it is added **after** Gross Profit; including it in Net Sales would overstate the profit made from trading inventory.

Question 5

GST paid = \$2 800 + \$240 + \$60 + \$1 200 = \$4 300. Net Operating = (\$46 000 + \$4 600) – (\$28 000 + \$7 500 + \$2 400 + \$600 + \$180 + \$4 300) = \$50 600 – \$42 980 = \$7 620. Net Investing = (\$12 000). Net Financing = \$4 000 + \$6 000 – \$2 000 – \$700 = \$7 300.

Cash Flow Statement for the month ended 30 September 2025

Copperleaf Kitchens	\$	\$
Operating activities		
Cash sales	46 000	
GST received	4 600	
Cash purchases of inventory	(28 000)	
Wages	(7 500)	
Rent expense	(2 400)	
Advertising	(600)	
Interest expense	(180)	

Copperleaf Kitchens	\$	\$
GST paid	(4 300)	
Net cash from Operating activities		7 620
Investing activities		
Purchase of vehicle	(12 000)	
Net cash used in Investing activities		(12 000)
Financing activities		
Capital contribution	4 000	
Loan – Riverbank	6 000	
Drawings	(2 000)	
Loan repayment	(700)	
Net cash from Financing activities		7 300
Net increase in cash		2 920
Add: Bank balance at start (1 September)		3 500
Bank balance at end (30 September)		6 420

b. Net change = \$7 620 – \$12 000 + \$7 300 = \$2 920. Opening \$3 500 + \$2 920 = **\$6 420** = closing Bank balance. ✓

c. Cash purchases of inventory should be classified as an **Operating** activity, because buying inventory is part of the business's **day-to-day trading**; Investing is reserved for the purchase and sale of **non-current assets**.

Question 6

a. Correctly, Gross Profit = \$50 000 – \$32 000 = \$18 000; total expenses = \$7 000 + \$2 500 + \$500 = \$10 000; Net Profit = \$18 000 – \$10 000 = \$8 000.

Income Statement for the month ended 31 October 2025

Highfield Trading	\$	\$
Revenue		
Cash Sales	50 000	
Net Sales		50 000
less Cost of Sales		(32 000)
Gross Profit		18 000
less Expenses		
Wages	7 000	
Rent expense	2 500	
Advertising	500	
Total expenses		(10 000)
Net Profit		8 000

Gross Profit = **\$18 000**; Net Profit = **\$8 000**.

b. Under the owner's proposal, only \$28 000 of Cost of Sales would be deducted above the line, so the reported "Gross Profit" would be \$50 000 – \$28 000 = **\$22 000** — overstating the true Gross Profit by \$4 000. (Net

Profit would be unchanged at \$8 000, because the \$4 000 is merely shifted into the other expenses below the line.)

- c. All \$32 000 is the cost of the inventory **sold**, so the whole amount belongs above the Gross Profit line; moving \$4 000 of it below the line makes the report a **misleading** rather than a **faithful representation** — it is neither **free from material error** nor **neutral**, because it dresses up the gross profit margin to flatter the trading result. A prospective buyer relying on the inflated \$22 000 Gross Profit (and the better gross profit margin it implies) would judge the trading to be stronger than it is and may **overpay** for the business; the misstatement also destroys **comparability** with other periods and other firms that classify Cost of Sales correctly, and would damage the owner's credibility once discovered. The ethical course is to deduct the full \$32 000 Cost of Sales above the line and report the true Gross Profit of \$18 000.

Question 7

Net Sales = \$76 000 – \$4 000 = \$72 000; Gross Profit = \$72 000 – \$44 000 = \$28 000; total expenses = \$11 000 + \$3 500 + \$900 + \$600 + \$400 = \$16 400; Net Profit = \$28 000 – \$16 400 = \$11 600.

Income Statement for the month ended 30 November 2025

Meadowlark Bakery		
Supplies	\$	\$
Revenue		
Sales	76 000	
less Sales Returns	(4 000)	
Net Sales		72 000
less Cost of Sales		(44 000)
Gross Profit		28 000
less Expenses		
Wages	11 000	
Rent expense	3 500	
Advertising	900	
Electricity	600	
Interest expense	400	
Total expenses		(16 400)
Net Profit		11 600

Net Sales = **\$72 000**; Gross Profit = **\$28 000**; Net Profit = **\$11 600**.

Question 8

GST paid = \$4 000 + \$300 + \$80 + \$1 500 = \$5 880. Net Operating = (\$64 000 + \$6 400) – (\$40 000 + \$9 000 + \$3 000 + \$800 + \$350 + \$5 880) = \$70 400 – \$59 030 = \$11 370. Net Investing = (\$15 000). Net Financing = \$5 000 + \$8 000 – \$3 500 – \$1 000 = \$8 500.

Cash Flow Statement for the month ended 31 December 2025

Stormont Electrical		
Wholesale	\$	\$
Operating activities		
Cash sales	64 000	
GST received	6 400	
Cash purchases of inventory	(40 000)	
Wages	(9 000)	

Stormont Electrical Wholesale	\$	\$
Rent expense	(3 000)	
Advertising	(800)	
Interest expense	(350)	
GST paid	(5 880)	
Net cash from Operating activities		11 370
Investing activities		
Purchase of forklift	(15 000)	
Net cash used in Investing activities		(15 000)
Financing activities		
Capital contribution	5 000	
Loan – CityBank	8 000	
Drawings	(3 500)	
Loan repayment	(1 000)	
Net cash from Financing activities		8 500
Net increase in cash		4 870
Add: Bank balance at start (1 December)		7 000
Bank balance at end (31 December)		11 870

Net change = \$11 370 – \$15 000 + \$8 500 = \$4 870; closing Bank = \$7 000 + \$4 870 = **\$11 870**. ✓

Question 9

Income Statement: Net Sales \$90 000 (no returns) – Cost of Sales \$52 000 = Gross Profit \$38 000; total expenses \$14 000 + \$4 000 + \$1 200 + \$500 = \$19 700; Net Profit = **\$18 300**. Cash Flow Statement: GST paid = \$5 800 + \$400 + \$120 + \$1 000 = \$7 320; Net Operating = (\$90 000 + \$9 000) – (\$58 000 + \$14 000 + \$4 000 + \$1 200 + \$500 + \$7 320) = \$99 000 – \$85 020 = \$13 980; Net Investing = (\$10 000); Net Financing = \$6 000 + \$12 000 – \$5 000 – \$1 500 = \$11 500; net increase = \$15 480; closing Bank = **\$21 980**.

Income Statement for the month ended 31 January 2026

Ashgrove Timber & Tools	\$	\$
Revenue		
Cash Sales	90 000	
Net Sales		90 000
less Cost of Sales		(52 000)
Gross Profit		38 000
less Expenses		
Wages	14 000	
Rent expense	4 000	
Advertising	1 200	
Interest expense	500	
Total expenses		(19 700)

Net Profit		18 300
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Cash Flow Statement for the month ended 31 January 2026

Operating activities

Cash sales	90 000
GST received	9 000
Cash purchases of inventory	(58 000)
Wages	(14 000)
Rent expense	(4 000)
Advertising	(1 200)
Interest expense	(500)
GST paid	(7 320)

Net cash from Operating activities	13 980
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Investing activities

Purchase of equipment	(10 000)
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Net cash used in Investing activities	(10 000)
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Financing activities

Capital contribution	6 000
Loan – Bayside Finance	12 000
Drawings	(5 000)
Loan repayment	(1 500)

Net cash from Financing activities	11 500
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Net increase in cash	15 480
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Add: Bank balance at start (1 January)	6 500
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Bank balance at end (31 January)	21 980
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The Net Profit of \$18 300 exceeds the net increase in cash of \$15 480. The main trading reason is inventory: the Income Statement is charged with the **\$52 000 Cost of Sales** (goods sold), while the Bank paid **\$58 000 for inventory** (goods bought) — the firm **bought \$6 000 more than it sold**, so cash fell by \$6 000 more than profit did on this account. In addition, several **cash flows are neither revenue nor expenses**: the \$6 000 capital and \$12 000 loan **raised** cash without adding to profit, while the \$5 000 drawings, \$1 500 loan repayment and \$10 000 equipment purchase **reduced** cash without being expenses; the \$9 000 GST received and \$7 320 GST paid also move cash without touching profit. Net Profit measures trading performance; the change in Bank measures the movement in cash.

Question 10

Where selling is the only reason inventory leaves the cards, the relationship is **purchases – Cost of Sales = the change in inventory on hand** (equivalently, Cost of Sales = opening inventory + purchases – closing inventory):

- **Month 1:** \$30 000 – \$25 000 = **+\$5 000** — inventory **rose** by \$5 000 (bought more than sold).
- **Month 2:** \$22 000 – \$28 000 = **–\$6 000** — inventory **fell** by \$6 000 (sold more than bought).
- **Month 3:** \$26 000 – \$26 000 = **\$0** — inventory was **unchanged** (bought exactly what it sold).

In every month the \$-figure for purchases is the **cash outflow** in the Cash Flow Statement and the Cost of Sales is the **expense** in the Income Statement; the two are equal only in Month 3, when the quantity bought exactly matched the quantity sold.

Question 11

Item	Report(s)	Cash Flow activity
(i) Cost of Sales	Income Statement only (expense, deducted from Net Sales)	—
(ii) Cash purchases of inventory	Cash Flow Statement only	Operating (outflow)
(iii) Cash sales	Both — Sales/revenue (IS) and cash received (CFS)	Operating (inflow)
(iv) Sales Returns	Income Statement (deducted from Sales to give Net Sales)	—
(v) Cash purchase of a delivery van	Cash Flow Statement only	Investing (outflow)
(vi) Capital contribution	Cash Flow Statement only	Financing (inflow)
(vii) Wages paid	Both — expense (IS) and cash paid (CFS)	Operating (outflow)
(viii) Drawings	Cash Flow Statement only	Financing (outflow)
(ix) Closing inventory	Neither — it is a Balance Sheet current asset	—
(x) Interest expense paid	Both — expense (IS) and cash paid (CFS)	Operating (outflow)
(xi) GST paid to the ATO	Cash Flow Statement only	Operating (outflow)
(xii) Loan repayment	Cash Flow Statement only	Financing (outflow)

The pattern: an item that is **both earned/incurred and settled in cash this period** (cash sales, wages, interest expense) appears in **both** reports; a **pure cost-of-goods-sold or asset value** (Cost of Sales, closing inventory) never appears in the Cash Flow Statement; and a **pure cash movement that is not a revenue or expense** (cash purchases of inventory, van, capital, drawings, GST, loan repayment) appears only in the Cash Flow Statement.

Question 12

Net Sales = \$96 000 – \$6 000 = \$90 000; Gross Profit = \$90 000 – \$55 000 = \$35 000; total other revenue = \$500 + \$400 = \$900; total expenses = \$13 500 + \$4 200 + \$1 100 + \$700 + \$500 = \$20 000; Net Profit = \$35 000 + \$900 – \$20 000 = \$15 900.

Income Statement for the month ended 28 February 2026

Willowmere Garden
Centre

	\$	\$
Revenue		
Sales	96 000	
less Sales Returns	(6 000)	
Net Sales		90 000
less Cost of Sales		(55 000)
Gross Profit		35 000
add Other Revenue		
Interest revenue	500	
Rent revenue	400	
Total other revenue		900

less Expenses

Wages	13 500	
Rent expense	4 200	
Advertising	1 100	
Electricity	700	
Interest expense	500	
Total expenses		(20 000)
Net Profit		15 900

Gross Profit = \$35 000; Net Profit = \$15 900.

Question 13

GST paid = \$2 000 + \$220 + \$50 + \$1 400 = \$3 670; GST received = \$3 800 (sales) + \$300 (on the disposal) = \$4 100, so the net GST position is \$4 100 – \$3 670 = **\$430 payable**. Net Operating = (\$38 000 + \$4 100) – (\$20 000 + \$6 500 + \$2 200 + \$500 + \$200 + \$3 670) = \$42 100 – \$33 070 = \$9 030. Net Investing = \$3 000 – \$14 000 = (\$11 000). Net Financing = –\$2 500 – \$1 000 = (\$3 500).

Cash Flow Statement for the month ended 31 March 2026

Redcliff Marine Supplies	\$	\$
Operating activities		
Cash sales	38 000	
GST received	4 100	
Cash purchases of inventory	(20 000)	
Wages	(6 500)	
Rent expense	(2 200)	
Advertising	(500)	
Interest expense	(200)	
GST paid	(3 670)	
Net cash from Operating activities		9 030
Investing activities		
Proceeds from sale of equipment	3 000	
Purchase of equipment	(14 000)	
Net cash used in Investing activities		(11 000)
Financing activities		
Drawings	(2 500)	
Loan repayment	(1 000)	
Net cash used in Financing activities		(3 500)
Net decrease in cash		(5 470)
Add: Bank balance at start (1 March)		4 000

Redcliff Marine Supplies	\$	\$
Bank balance at end (31 March)		(1 470)

Interpretation: although the business generated a healthy **\$9 030** of operating cash, the large **\$14 000** cash purchase of new equipment — only partly offset by the \$3 000 proceeds from the old equipment — together with \$3 500 of drawings and loan repayment, drained cash by a net **\$5 470**. The Bank has moved from \$4 000 in funds to a **\$1 470 overdraft** (a current liability). Trading itself was cash-positive; the overdraft is the result of the scale and timing of the investing and financing outflows.

Question 14

By reconstruction — sales being the only reason inventory left — Cost of Sales = opening inventory + purchases – closing inventory, so purchases = Cost of Sales + (closing – opening) = \$120 000 + (\$21 000 – \$15 000) = \$120 000 + \$6 000 = **\$126 000** (ex-GST). Because all inventory was bought for cash, the cash paid for inventory is \$126 000 plus 10% GST = \$126 000 + \$12 600 = **\$138 600** including GST. Reporting: the **\$120 000 Cost of Sales** is an expense in the **Income Statement**; the **\$126 000 cash paid for inventory** (ex-GST) is an Operating outflow in the **Cash Flow Statement** (the \$12 600 GST is included in Operating GST paid); and the **\$21 000 closing inventory** is a current asset in the **Balance Sheet**. The business bought \$6 000 more inventory than it sold, which is why the cash paid for inventory exceeds the Cost of Sales by exactly the \$6 000 rise in the Inventory asset.

Question 15

Net Sales = \$44 000 – \$3 000 = \$41 000; Gross Profit = \$41 000 – \$28 000 = \$13 000; total expenses = \$9 000 + \$3 000 + \$900 + \$600 + \$500 = \$14 000. Because the expenses exceed the Gross Profit, the result is a **Net Loss** of \$14 000 – \$13 000 = \$1 000.

Income Statement for the month ended 30 April 2026

Glenhaven Outdoor Living	\$	\$
Revenue		
Sales	44 000	
less Sales Returns	(3 000)	
Net Sales		41 000
less Cost of Sales		(28 000)
Gross Profit		13 000
less Expenses		
Wages	9 000	
Rent expense	3 000	
Advertising	900	
Electricity	600	
Interest expense	500	
Total expenses		(14 000)
Net Loss		(1 000)

The month produced a **Net Loss of \$1 000**: the trading itself was profitable (a positive Gross Profit of \$13 000), but the other expenses of \$14 000 **exceeded** that Gross Profit, so overall the month **reduced** the owner's equity. The owner needs either to lift Gross Profit (higher sales or margin) or to cut the overheads.

Question 16

A **profit** measures **revenue earned less expenses incurred**, whereas the **change in cash** measures **cash received less cash paid** — and the two diverge sharply for a trading firm. The clearest reason here is the inventory distinction: profit is reduced by only the **\$200 000 Cost of Sales** (the goods **sold**), but the Bank was reduced by the **\$240 000 cash paid for inventory** (the goods **bought**). The firm **bought \$40 000 more inventory than it sold**, so \$40 000 of cash

has been tied up in a larger Inventory asset that has **not** yet been charged as an expense — cash is gone, but profit is untouched by that \$40 000. **Two further reasons** the cash can fall while profit is earned: **drawings** and **loan (principal) repayments** reduce cash but are not expenses, and the **cash purchase of a non-current asset** (the new vehicle) is a large investing outflow that likewise never appears in the Income Statement. So a firm can trade profitably yet still see its Bank balance fall — a warning that profit and cash must both be managed.

Question 17

Under the **accrual basis** assumption, an expense is recognised when the economic benefit is **consumed**, not when cash is paid. The benefit of inventory is consumed when the goods are **sold**, so the expense of the period is the **Cost of Sales** — the cost of the units actually sold — matched against the sales they generated. The **cash paid for inventory** is a different amount, because it buys **all** the inventory purchased, some of which is **still on hand** at period end; that unsold inventory is a **current asset** (a future economic benefit), not an expense. Reporting the cash paid as the expense would therefore **overstate** expenses (and understate profit) in a period of stock-building, or understate them when stock is run down, giving a **misleading** picture. Charging the Cost of Sales instead makes the Income Statement a **faithful representation** of the period's trading — complete, free from material error and neutral (without bias) — and preserves the **relevance** of the profit figure for decisions, because it reflects the true cost of what was sold.

Question 18

Income Statement: Net Sales \$110 000 (no returns) – Cost of Sales \$60 000 = Gross Profit \$50 000; add Interest revenue \$600; total expenses \$18 000 + \$5 000 + \$1 500 + \$700 = \$25 200; Net Profit = \$50 000 + \$600 – \$25 200 = **\$25 400**. Cash Flow Statement: GST paid = \$6 600 + \$500 + \$150 + \$1 200 = \$8 450, so net GST = \$11 000 – \$8 450 = **\$2 550 payable**; Net Operating = (\$110 000 + \$11 000 + \$600) – (\$66 000 + \$18 000 + \$5 000 + \$1 500 + \$700 + \$8 450) = \$121 600 – \$99 650 = \$21 950; Net Investing = (\$12 000); Net Financing = \$10 000 + \$15 000 – \$6 000 – \$2 000 = \$17 000; net increase = \$26 950; closing Bank = **\$35 950**.

Income Statement for the month ended 31 May 2026

Kingfisher Trading Co	\$	\$
Revenue		
Cash Sales	110 000	
Net Sales		110 000
less Cost of Sales		(60 000)
Gross Profit		50 000
add Other Revenue		
Interest revenue	600	
Total other revenue		600
less Expenses		
Wages	18 000	
Rent expense	5 000	
Advertising	1 500	
Interest expense	700	
Total expenses		(25 200)
Net Profit		25 400

Cash Flow Statement for the month ended 31 May 2026

Kingfisher Trading Co	\$	\$
Operating activities		
Cash sales	110 000	
GST received	11 000	
Interest revenue	600	

Kingfisher Trading Co	\$	\$
Cash purchases of inventory	(66 000)	
Wages	(18 000)	
Rent expense	(5 000)	
Advertising	(1 500)	
Interest expense	(700)	
GST paid	(8 450)	
Net cash from Operating activities		21 950
Investing activities		
Purchase of shop fittings	(12 000)	
Net cash used in Investing activities		(12 000)
Financing activities		
Capital contribution	10 000	
Loan – Coastal Bank	15 000	
Drawings	(6 000)	
Loan repayment	(2 000)	
Net cash from Financing activities		17 000
Net increase in cash		26 950
Add: Bank balance at start (1 May)		9 000
Bank balance at end (31 May)		35 950

Gross Profit = **\$50 000**; Net Profit = **\$25 400**; closing Bank = **\$35 950**; net GST = **\$2 550 payable**. The Net Profit of \$25 400 differs from the \$26 950 net increase in cash. On the trading side, the Income Statement bears the **\$60 000 Cost of Sales** while the Bank paid **\$66 000 for inventory** (the firm bought \$6 000 more than it sold, lifting inventory from \$14 000 to \$20 000) — this pushes operating cash \$6 000 below what profit alone would suggest. Working the other way, the large **financing inflows** (\$10 000 capital and \$15 000 loan, less \$6 000 drawings and \$2 000 loan repayment = \$17 000) raised cash without adding to profit, and the **\$12 000 shop fittings** reduced cash without being an expense; the \$600 interest revenue appears in both reports, and the GST flows move cash only. On balance these non-operating inflows outweigh the inventory build-up, so the increase in cash (\$26 950) exceeds the Net Profit (\$25 400).

Chapter 12 Reporting and managing inventory — 12C Financial indicators and the Balance Sheet

Theory

A trading business does not sell its time; it buys inventory and sells it at a higher price. Its **Income Statement** therefore looks different from a service business's: before it can reach net profit, it must first work out the profit made on the goods themselves. Sections 12A and 12B built that report; this section uses it to **calculate and interpret two financial indicators** — the **Gross Profit Margin** and the **Net Profit Margin** — and then prepares the trading firm's **classified Balance Sheet**, in which **Inventory** appears as a **current asset**.

The trading Income Statement in brief. For a trading business the report moves in stages:

- **Sales less Sales Returns** gives **Net Sales** — the revenue actually earned from selling inventory once returns by customers are taken out.
- **Net Sales less Cost of Sales** (the cost price of the inventory sold) gives **Gross Profit** — the profit made on the goods before any other expenses.
- **Gross Profit less the business's other Expenses** (wages, rent, advertising, interest and the like) gives **Net Profit** — the final profit that belongs to the owner.

Worked model. Brookvale Bikes is a trading business. For the year ended 30 June 2026 its report is:

Income Statement for the year ended 30 June 2026

Brookvale Bikes	\$	\$
Revenue		
Sales	500 000	
less Sales Returns	20 000	
Net Sales		480 000
less Cost of Sales		288 000
Gross Profit		192 000
less Expenses		
Wages	70 000	
Rent expense	24 000	
Advertising	14 000	
Interest expense	12 000	
Total Expenses		(120 000)
Net Profit		72 000

Two profitability indicators. A dollar figure such as “Net Profit \$72 000” means little on its own — a large business will earn more profit than a small one simply because it sells more. To judge how **profitable** the trading actually is, the profit is expressed as a **percentage of Net Sales**. Two indicators do this.

The **Gross Profit Margin (GPM)** measures how much of every sales dollar is left as **gross profit** after the cost of the inventory sold has been covered:

$$\text{Gross Profit Margin} = (\text{gross profit} \div \text{net sales}) \times 100$$

It is expressed as a **percentage**, conventionally to one decimal place. For Brookvale Bikes the GPM is $(\$192\,000 \div \$480\,000) \times 100 = 40.0\%$, meaning the business keeps **40 cents of gross profit in every sales dollar**. The GPM reflects the relationship between **selling prices and cost prices** — the size of the **mark-up**. A GPM will fall if cost prices rise but selling prices do not, or if the business discounts its selling prices; it will rise if the business buys more cheaply or lifts its selling prices.

The **Net Profit Margin (NPM)** measures how much of every sales dollar is left as **net profit** after **all** expenses — cost of sales *and* the other operating expenses — have been met:

$$\text{Net Profit Margin} = (\text{net profit} \div \text{net sales}) \times 100$$

For Brookvale Bikes the NPM is $(\$72\,000 \div \$480\,000) \times 100 = \mathbf{15.0\%}$, meaning the business keeps **15 cents of net profit in every sales dollar**. Because the NPM takes *every* expense into account, it is always **lower** than the GPM (unless there is other revenue). The **gap between the two margins** is the business's **other expenses expressed as a percentage of net sales**: here $40.0\% - 15.0\% = \mathbf{25.0\%}$, so wages, rent, advertising and interest together consume 25 cents of every sales dollar ($\$120\,000 \div \$480\,000 = 25.0\%$).

Reading the two margins together. The margins are most useful when **compared** — with the same business in an earlier period, with its budget, or with a similar business. Read side by side they help locate *where* a change in profitability has come from:

- If the **GPM holds steady but the NPM falls**, the trading margin is unchanged, so the cause lies **below the gross-profit line** — usually in the **other expenses**, which have grown faster than sales.
- If the **GPM itself falls**, the problem is in the **trading margin** — cost prices have risen relative to selling prices, or selling prices have been cut — and this usually drags the NPM down with it.

A single figure, though, is never “good” or “bad” until it is compared: comparisons must be made between **like and like** (the qualitative characteristic of **comparability**), so a small retailer's margin should be judged against its own past or a similar retailer, not against a business of a different type.

The classified Balance Sheet for a trading business. The **Balance Sheet** reports the business's **financial position** — its **assets, liabilities and owner's equity** — as at a **single date**, classified under the five headings **Current Assets, Non-Current Assets, Current Liabilities, Non-Current Liabilities** and **Owner's Equity**. A trading business's Balance Sheet is set out exactly like a service business's, with two important trading features:

- **Inventory is a current asset.** Inventory is held in order to be **sold within the next 12 months**, converting it to cash (or to an account receivable), so it satisfies the 12-month test for a **current asset**. It is listed among the current assets alongside Bank, Accounts Receivable and any prepaid expenses.
- **GST Clearing** is usually a **current liability** — the net GST owed to the Australian Taxation Office and payable within the next period (occasionally a current asset, when a refund is due).

The **Net Profit** from the Income Statement flows into the **Owner's Equity** section, where the closing **Capital** is reconstructed:

$$\text{Capital (closing)} = \text{Capital (opening)} + \text{Net Profit} - \text{Drawings}$$

Net profit is **added** because it is earned *for* the owner; **drawings** (including any inventory the owner takes for private use) are **deducted**. The resulting closing Capital is the single Owner's Equity figure that makes the report balance: **Total Assets = Total Liabilities + Owner's Equity**.

Balance Sheet of Brookvale Bikes as at 30 June 2026

	\$	\$
Current Assets		
Bank	18 000	
Accounts Receivable	32 000	
Inventory	60 000	
Prepaid insurance	4 000	114 000
Non-Current Assets		
Shop fittings	40 000	
Motor vehicle	46 000	86 000
Total Assets		200 000

	\$	\$
Current Liabilities		
Accounts Payable	24 000	
GST Clearing	6 000	30 000
Non-Current Liabilities		
Loan – Meridian Bank		50 000
Total Liabilities		80 000
Owner's Equity		
Capital (opening)	88 000	
Add Net Profit	72 000	
	160 000	
Less Drawings	40 000	120 000
Total Liabilities and Owner's Equity		200 000

Total Assets of \$200 000 equal Total Liabilities plus Owner's Equity (\$80 000 + \$120 000), so the report balances. Inventory of \$60 000 is reported as a current asset because it is expected to be sold within the year, and the year's \$72 000 net profit has lifted the owner's closing Capital to \$120 000.

Ethical considerations. Because the margins and the Balance Sheet are read by outsiders — most often a **lender** or a prospective **buyer** — the owner has an ethical duty to prepare them as a **faithful representation**: complete, free from material error and neutral (without bias). A trading business faces a temptation a service business does not: **overstating closing inventory**. The **inventory cards** show what the business *should* hold; the **physical count** shows what it *actually* holds. Reporting a closing figure the count does not support — leaving an **inventory loss** the count has revealed unrecorded, or recording an **inventory gain** that never occurred — overstates the **Inventory** current asset in the Balance Sheet and, because inventory losses and gains are reported **after Gross Profit** (section 12A), inflates **Net Profit** and the **Net Profit Margin**. Note where the manipulation does *not* show: **Cost of Sales** is taken from the cards as the goods go out, so **Gross Profit and the Gross Profit Margin are unchanged** — a reminder that a movement in the Net Profit Margin the Gross Profit Margin does not explain always has its cause **below the gross-profit line**. Equally misleading is “**window dressing**” the Balance Sheet by misclassifying items — showing a debt due next month as non-current so the business looks more able to meet its short-term obligations. Such choices give a lender an inflated view of profitability and position, may lead to funds being advanced that the business cannot service, and damage the owner's reputation once the true position emerges. Ethical reporting values inventory at the amount actually on hand, records every asset and liability completely and honestly, and lets the reader judge the business on its real performance.

Worked examples (scaffolded)

Example 1 — calculating and interpreting the Gross Profit Margin and Net Profit Margin

Harlow Homewares is a trading business. Its Income Statement for the year ended 30 June 2026 shows Sales \$620 000, Sales Returns \$20 000, Cost of Sales \$330 000, and total expenses of \$150 000 (Wages \$90 000, Rent expense \$30 000, Advertising \$20 000, Interest expense \$10 000). Calculate the Gross Profit Margin and the Net Profit Margin, and interpret each.

Working	Comment
Net Sales = Sales \$620 000 – Sales Returns \$20 000 = \$600 000 .	Returns by customers are deducted from Sales to give the revenue actually earned.
Gross Profit = Net Sales \$600 000 – Cost of Sales \$330 000 = \$270 000 .	The profit on the goods, before other expenses.
Net Profit = Gross Profit \$270 000 – total expenses \$150 000 = \$120 000 .	All other expenses are then deducted to reach net profit.
GPM = (\$270 000 ÷ \$600 000) × 100 = 45.0% .	45 cents of gross profit in every sales dollar.

Working	Comment
NPM = $(\$120\,000 \div \$600\,000) \times 100 = \mathbf{20.0\%}$.	20 cents of net profit in every sales dollar.
<i>Interpret:</i> the 25.0-point gap ($45.0\% - 20.0\%$) is the other expenses as a share of sales — $\$150\,000 \div \$600\,000 = \mathbf{25.0\%}$.	The NPM is always below the GPM by the other-expenses percentage.

$\therefore$ Harlow Homewares keeps 45 cents of gross profit and 20 cents of net profit from every sales dollar; its wages, rent, advertising and interest together absorb the other 25 cents.

Example 2 — preparing the classified Balance Sheet for a trading business

Eastgate Sports (owner R. Eastgate) is a trading business. At 30 June 2026 it had: Bank \$14 000; Accounts Receivable \$26 000; Inventory \$55 000; Prepaid insurance \$5 000 (cover expiring in eight months); Shop fittings \$50 000; Motor vehicle \$40 000; Accounts Payable \$20 000; GST Clearing \$5 000; and a Loan from Anchor Bank of \$45 000 (repayable over five years). The owner's Capital was \$100 000 at 1 July 2025; the business earned a Net Profit of \$55 000 for the year and the owner took \$35 000 of drawings. Prepare the classified Balance Sheet.

Working	Comment
Current assets: Bank, Accounts Receivable, Inventory and Prepaid insurance (eight months) = $\$14\,000 + \$26\,000 + \$55\,000 + \$5\,000 = \mathbf{\$100\,000}$.	Inventory is a current asset — it is held to be sold within 12 months.
Non-current assets: Shop fittings \$50 000 + Motor vehicle \$40 000 = \$90 000 ; Total Assets = \$190 000 .	Assets used to run the business beyond 12 months.
Current liabilities: Accounts Payable \$20 000 + GST Clearing \$5 000 = \$25 000 ; the five-year loan is a non-current liability \$45 000; Total Liabilities = \$70 000 .	GST owed to the ATO is a current liability.
Owner's Equity: closing Capital = $\$100\,000 + \text{Net Profit } \$55\,000 - \text{Drawings } \$35\,000 = \mathbf{\$120\,000}$.	Net profit is added, drawings deducted.
Check: $\$70\,000 + \$120\,000 = \mathbf{\$190\,000} = \text{Total Assets}$.	The report balances.

Balance Sheet of Eastgate Sports as at 30 June 2026

	\$	\$
Current Assets		
Bank	14 000	
Accounts Receivable	26 000	
Inventory	55 000	
Prepaid insurance	5 000	100 000
Non-Current Assets		
Shop fittings	50 000	
Motor vehicle	40 000	90 000
Total Assets		190 000
Current Liabilities		
Accounts Payable	20 000	
GST Clearing	5 000	25 000
Non-Current Liabilities		
Loan – Anchor Bank		45 000
Total Liabilities		70 000
Owner's Equity		
Capital (opening)	100 000	

	\$	\$
Add Net Profit	55 000	
	155 000	
Less Drawings	35 000	120 000
Total Liabilities and Owner's Equity		190 000

Worked examples (unscaffolded)

Example 3 — interpreting a change in the margins over two years

Delford Trading reports Net Sales \$400 000, Gross Profit \$180 000 and Net Profit \$60 000 for the year ended 30 June 2025, and Net Sales \$480 000, Gross Profit \$216 000 and Net Profit \$48 000 for the year ended 30 June 2026.

Calculate the Gross Profit Margin and the Net Profit Margin for each year, and explain what has happened to the business's profitability.

In 2025 the GPM is $(\$180\,000 \div \$400\,000) \times 100 = 45.0\%$ and the NPM is $(\$60\,000 \div \$400\,000) \times 100 = 15.0\%$. In 2026 the GPM is $(\$216\,000 \div \$480\,000) \times 100 = 45.0\%$ and the NPM is $(\$48\,000 \div \$480\,000) \times 100 = 10.0\%$. The **GPM is unchanged** at 45.0%, so the business's trading margin — the relationship between its selling prices and its cost prices — has held firm. But the **NPM has fallen** by 5.0 percentage points, from 15.0% to 10.0%. Because the gross margin is steady while the net margin has dropped, the deterioration lies **below the gross-profit line, in the other expenses**: they have risen from \$120 000 to \$168 000 and, as a share of sales, from 30.0% to 35.0% ($\$120\,000 \div \$400\,000$ versus $\$168\,000 \div \$480\,000$).

∴ the trading itself is as profitable per dollar as before, but rising other expenses have cut the share of each sales dollar kept as net profit; the business should review and control those expenses.

Example 4 — preparing a trading Balance Sheet with a loan split across two groups

Rosedale Hardware (owner P. Rosedale) is a trading business. At 30 June 2026 it had: Bank \$9 000; Accounts Receivable \$21 000; Inventory \$48 000; Prepaid advertising \$2 000; Warehouse fittings \$60 000; Forklift \$40 000; Accounts Payable \$16 000; GST Clearing \$4 000; and Capital \$100 000. It also has a Loan from Delta Finance of \$60 000, of which \$10 000 is repayable within the next 12 months and \$50 000 beyond. Prepare the classified Balance Sheet.

The \$10 000 of the loan due within a year is a **current liability**; the \$50 000 due later is a **non-current liability**, so the one debt appears on two lines. Inventory of \$48 000 is a current asset. Current Assets total \$80 000, Non-Current Assets \$100 000, giving Total Assets of \$180 000; Total Liabilities are \$30 000 current plus \$50 000 non-current = \$80 000, and with Capital of \$100 000 the report balances at \$180 000.

Balance Sheet of Rosedale Hardware as at 30 June 2026

	\$	\$
Current Assets		
Bank	9 000	
Accounts Receivable	21 000	
Inventory	48 000	
Prepaid advertising	2 000	80 000
Non-Current Assets		
Warehouse fittings	60 000	
Forklift	40 000	100 000
Total Assets		180 000
Current Liabilities		
Accounts Payable	16 000	

	\$	\$
GST Clearing	4 000	
Loan – Delta Finance (current portion)	10 000	30 000
Non-Current Liabilities		
Loan – Delta Finance		50 000
Total Liabilities		80 000
Owner's Equity		
Capital		100 000
Total Liabilities and Owner's Equity		180 000

∴ the same \$60 000 loan is reported as \$10 000 current and \$50 000 non-current, Inventory sits among the current assets, and the Balance Sheet balances at \$180 000.

Practice questions — scaffolded

Question 1

Meadowbrook Menswear, a trading business, reports for the year ended 30 June 2026: Net Sales \$500 000, Gross Profit \$200 000 and Net Profit \$60 000.

- Calculate the Gross Profit Margin.
- Calculate the Net Profit Margin.
- State, in cents per sales dollar, what each margin means.

Question 2

Cliffon Cycles, a trading business, reports for the year ended 30 June 2026: Sales \$420 000; Sales Returns \$20 000; Cost of Sales \$240 000; and expenses of Wages \$60 000, Rent expense \$20 000, Advertising \$12 000 and Interest expense \$8 000.

- Calculate Net Sales, Gross Profit and Net Profit.
- Calculate the Gross Profit Margin and the Net Profit Margin.
- Explain in one sentence what the Net Profit Margin tells the owner.

Question 3

Brightwater Books (owner L. Brightwater), a trading business, had at 30 June 2026: Bank \$11 000; Accounts Receivable \$15 000; Inventory \$44 000; Shop fittings \$30 000; Motor vehicle \$20 000; Accounts Payable \$12 000; GST Clearing \$3 000; Loan – Coastwide Bank \$35 000 (repayable over four years); Capital \$70 000.

- Classify each item as a current asset, non-current asset, current liability, non-current liability or owner's equity.
- Prepare a classified Balance Sheet as at 30 June 2026.
- State which item is the business's inventory, and explain in one sentence why it is a current asset.

Question 4

Thornbury Toys (owner D. Thornbury), a trading business, had at 30 June 2026: Bank \$10 000; Accounts Receivable \$20 000; Inventory \$45 000; Prepaid insurance \$5 000; Equipment \$44 000; Motor vehicle \$36 000; Accounts Payable \$18 000; GST Clearing \$2 000; Loan – Summit Bank \$40 000 (repayable over five years). The owner's Capital was \$80 000 at 1 July 2025; the business earned a Net Profit of \$50 000 and the owner took \$30 000 of drawings.

- a. Calculate the closing Capital.
- b. Prepare a classified Balance Sheet as at 30 June 2026, showing the net profit and drawings in the Owner's Equity section.
- c. State the Total Assets of the business.

Question 5

Fernwood Furniture, a trading business, reports Net Sales \$500 000, Gross Profit \$225 000 and Net Profit \$75 000 for the year ended 30 June 2025, and Net Sales \$520 000, Gross Profit \$208 000 and Net Profit \$52 000 for the year ended 30 June 2026.

- a. Calculate the Gross Profit Margin for each year.
- b. Calculate the Net Profit Margin for each year.
- c. Interpret the change in the two margins, stating where the fall in profitability has come from.

Question 6

Oakridge Outdoors, a trading business, reports for the year ended 30 June 2026: Sales \$790 000; Sales Returns \$40 000; Cost of Sales \$420 000; and total expenses of \$180 000.

- a. Calculate Net Sales, Gross Profit and Net Profit.
- b. Calculate the Gross Profit Margin and the Net Profit Margin.
- c. The business's Inventory at 30 June 2026 is \$70 000. State where it is reported in the Balance Sheet, and explain in one sentence why.

Practice questions — unscaffolded

Question 7

Sunhaven Surf, a trading business, reports Net Sales \$800 000, Gross Profit \$360 000 and Net Profit \$96 000 for the year ended 30 June 2026. Calculate the Gross Profit Margin and the Net Profit Margin, and state what each means in cents per sales dollar.

Question 8

Fairhaven Living, a trading business, reports for the year ended 30 June 2026: Sales \$460 000; Sales Returns \$10 000; Cost of Sales \$270 000; and expenses of Wages \$55 000, Rent expense \$18 000, Advertising \$9 000 and Interest expense \$8 000. Prepare the trading Income Statement, then calculate the Gross Profit Margin and the Net Profit Margin.

Question 9

Pinehill Pantry (owner V. Pinehill), a trading business, had at 30 June 2026: Bank \$6 000; Accounts Receivable \$14 000; Inventory \$52 000; Prepaid insurance \$8 000; Shop fittings \$40 000; Delivery vehicle \$30 000; Accounts Payable \$15 000; GST Clearing \$5 000; and Capital \$70 000. It has a Loan from Baytown Bank of \$60 000, of which \$10 000 is repayable within the next 12 months and \$50 000 beyond. Prepare the classified Balance Sheet and state the Total Assets.

Question 10

Maplewood Markets, a trading business, reports Net Sales \$600 000, Gross Profit \$240 000 and Net Profit \$90 000 for the year ended 30 June 2025, and Net Sales \$720 000, Gross Profit \$288 000 and Net Profit \$72 000 for the year ended 30 June 2026. Calculate the Gross Profit Margin and the Net Profit Margin for each year, interpret the change, and identify the likely cause.

Question 11

Aspendale Apparel and Belmore Boutique are two trading businesses, each with Net Sales of \$500 000 for the year ended 30 June 2026. Aspendale reports Gross Profit \$225 000 and Net Profit \$50 000; Belmore reports Gross Profit

\$185 000 and Net Profit \$70 000. Calculate the Gross Profit Margin and the Net Profit Margin for each, and discuss which business converts sales to gross profit more effectively and which is more profitable overall, giving a reason.

Question 12

Answer each part using the margin formulas.

- A trading business has Net Sales of \$400 000 and a Gross Profit Margin of 45%. Calculate its Gross Profit and its Cost of Sales.
- A trading business has Net Sales of \$600 000 and a Net Profit Margin of 12%. Calculate its Net Profit.
- A trading business has a Gross Profit of \$150 000 and a Gross Profit Margin of 40%. Calculate its Net Sales.

Question 13

Westgate Wholesalers (owner C. Westgate), a trading business, had at 30 June 2026: Bank \$12 000; Accounts Receivable \$30 000; Inventory \$68 000; Equipment \$50 000; Motor vehicles \$60 000; Accounts Payable \$22 000; GST Clearing \$8 000; Loan – Ironbark Bank \$60 000 (repayable over six years). The owner's Capital was \$110 000 at 1 July 2025; the business earned a Net Profit of \$66 000 and the owner took \$46 000 of drawings. Prepare the classified Balance Sheet as at 30 June 2026.

Question 14

Hazelwood Homeware, a trading business, reports Net Sales \$500 000, Gross Profit \$200 000 and Net Profit \$65 000 for the year ended 30 June 2026. The owner's Capital was \$90 000 at 1 July 2025 and the owner took \$40 000 of drawings. Calculate the Gross Profit Margin and the Net Profit Margin, prepare the Owner's Equity section of the Balance Sheet as at 30 June 2026, and state the closing Capital.

Question 15

Explain each of the following in a sentence or two.

- Why Inventory is classified as a **current asset** in a trading firm's Balance Sheet.
- Why a service business has **no** Gross Profit Margin.
- What the **gap** between a trading business's Gross Profit Margin and its Net Profit Margin represents.
- Why a single Gross Profit Margin figure means little until it is **compared**, and what makes a comparison valid.

Question 16

Cranbourne Crafts, a trading business, reports Net Sales \$400 000, Gross Profit \$160 000 and Net Profit \$48 000 for the year ended 30 June 2025, and Net Sales \$440 000, Gross Profit \$198 000 and Net Profit \$44 000 for the year ended 30 June 2026. Calculate the Gross Profit Margin and the Net Profit Margin for each year, and explain how the Gross Profit Margin and the Net Profit Margin can move in **opposite directions**, identifying what must have happened to the other expenses.

Question 17

Glenholme Groceries (owner F. Glenholme) is applying to a bank for a loan. The business records its inventory on **inventory cards**. Its correct figures for the year ended 30 June 2026 are Net Sales \$600 000, Gross Profit \$210 000 and Net Profit \$54 000, with closing Inventory of \$60 000 — the cards and the physical count agree. Wanting the reports to look as strong as possible, the owner proposes to (i) record closing Inventory at \$78 000 rather than the \$60 000 counted, and (ii) show a bank loan due next month as a non-current liability. Calculate the correct Gross Profit Margin and Net Profit Margin, and the margins that would be reported if action (i) were taken; then discuss the ethical considerations raised by the owner's proposals, referring to a relevant qualitative characteristic and to the effect on the bank, and state what should be done.

Question 18

Rivergum Retail (owner A. Rivergum), a trading business, reports for the year ended 30 June 2026: Sales \$820 000; Sales Returns \$20 000; Cost of Sales \$440 000; and expenses of Wages \$120 000, Rent expense \$40 000, Advertising \$24 000 and Interest expense \$16 000. At 30 June 2026 its assets and liabilities are: Bank \$20 000; Accounts Receivable \$50 000; Inventory \$80 000; Prepaid insurance \$10 000; Shop fittings \$90 000; Motor vehicles \$100 000; Accounts Payable \$30 000; GST Clearing \$10 000; and a Loan from Zenith Bank of \$110 000, of which \$20 000 is repayable within 12 months and \$90 000 beyond. The owner's Capital was \$140 000 at 1 July 2025 and the owner took \$100 000 of drawings. Prepare the trading Income Statement, calculate the Gross Profit Margin and the Net Profit Margin, and prepare the classified Balance Sheet as at 30 June 2026 to confirm it balances.

Answers

1.
 - a. GPM **40.0%** b. NPM **12.0%** c. 40c gross profit and 12c net profit per sales dollar
2.
 - a. Net Sales \$400 000; Gross Profit \$160 000; Net Profit \$60 000 b. GPM **40.0%**, NPM **15.0%**
3.
 - c. Inventory \$44 000 — a current asset (held to be sold within 12 months); Balance Sheet balances at \$120 000
4.
 - a. Closing Capital \$100 000 c. Total Assets \$160 000
5.
 - a. GPM 45.0% → 40.0% b. NPM 15.0% → 10.0% c. GPM fell, so the fall is in the trading margin (cost of sales up relative to sales)
6.
 - a. Net Sales \$750 000; Gross Profit \$330 000; Net Profit \$150 000 b. GPM **44.0%**, NPM **20.0%** c. A current asset (held to be sold within 12 months)
7. GPM **45.0%** (45c), NPM **12.0%** (12c) per sales dollar
8. Net Sales \$450 000; Gross Profit \$180 000; Net Profit \$90 000; GPM **40.0%**, NPM **20.0%**
9. Total Assets \$150 000 (balances; Current Liabilities \$30 000, Non-Current Liabilities \$50 000)
10. GPM 40.0% both years; NPM 15.0% → 10.0%; GPM steady but NPM fell → rising other expenses
11. Aspendale GPM 45.0%, NPM 10.0%; Belmore GPM 37.0%, NPM 14.0%; Aspendale converts sales to gross profit better, Belmore is more profitable overall
12.
 - a. Gross Profit \$180 000; Cost of Sales \$220 000 b. Net Profit \$72 000 c. Net Sales \$375 000
13. Balances at Total Assets \$220 000; closing Capital \$130 000
14. GPM **40.0%**, NPM **13.0%**; closing Capital \$115 000
15. See solutions
16. 2025 GPM 40.0%, NPM 12.0%; 2026 GPM 45.0%, NPM 10.0%; GPM rose but NPM fell → other expenses rose (28.0% → 35.0% of sales)
17. Correct GPM **35.0%**, NPM **9.0%**; with (i) GPM still **35.0%** (unchanged), NPM **12.0%** — see solutions
18. Net Sales \$800 000; Gross Profit \$360 000; Net Profit \$160 000; GPM **45.0%**, NPM **20.0%**; Balance Sheet balances at \$350 000

Fully-worked solutions

Question 1

- a. Gross Profit Margin = $(\$200\,000 \div \$500\,000) \times 100 = \mathbf{40.0\%}$.
- b. Net Profit Margin = $(\$60\,000 \div \$500\,000) \times 100 = \mathbf{12.0\%}$.
- c. The GPM of 40.0% means the business keeps **40 cents of gross profit** in every sales dollar; the NPM of 12.0% means it keeps **12 cents of net profit** in every sales dollar after all expenses. The 28-cent difference is the other expenses $(\$140\,000 \div \$500\,000 = 28.0\%$ of sales).

Question 2

- a. Net Sales = $\$420\,000 - \$20\,000 = \mathbf{\$400\,000}$; Gross Profit = $\$400\,000 - \$240\,000 = \mathbf{\$160\,000}$; total expenses = $\$60\,000 + \$20\,000 + \$12\,000 + \$8\,000 = \$100\,000$, so Net Profit = $\$160\,000 - \$100\,000 = \mathbf{\$60\,000}$.
- b. GPM = $(\$160\,000 \div \$400\,000) \times 100 = \mathbf{40.0\%}$; NPM = $(\$60\,000 \div \$400\,000) \times 100 = \mathbf{15.0\%}$.
- c. The Net Profit Margin tells the owner how many cents of **net profit** the business keeps from every dollar of net sales after **all** expenses — here 15 cents — a measure of overall profitability.

Question 3

- a. Current assets: Bank, Accounts Receivable, Inventory. Non-current assets: Shop fittings, Motor vehicle.
Current liabilities: Accounts Payable, GST Clearing. Non-current liability: Loan – Coastwide Bank. Owner's equity: Capital.

Balance Sheet of Brightwater Books as at 30 June 2026

	\$	\$
Current Assets		
Bank	11 000	
Accounts Receivable	15 000	
Inventory	44 000	70 000
Non-Current Assets		
Shop fittings	30 000	
Motor vehicle	20 000	50 000
Total Assets		120 000
Current Liabilities		
Accounts Payable	12 000	
GST Clearing	3 000	15 000
Non-Current Liabilities		
Loan – Coastwide Bank		35 000
Total Liabilities		50 000
Owner's Equity		
Capital		70 000
Total Liabilities and Owner's Equity		120 000

- c. The **Inventory of \$44 000** is a current asset because it is held to be **sold within the next 12 months**, converting it to cash or to an account receivable, so it meets the 12-month test.

Question 4

- a. Closing Capital = opening \$80 000 + Net Profit \$50 000 – Drawings \$30 000 = **\$100 000**.

Balance Sheet of Thornbury Toys as at 30 June 2026

	\$	\$
Current Assets		
Bank	10 000	
Accounts Receivable	20 000	
Inventory	45 000	
Prepaid insurance	5 000	80 000
Non-Current Assets		
Equipment	44 000	
Motor vehicle	36 000	80 000
Total Assets		160 000
Current Liabilities		
Accounts Payable	18 000	
GST Clearing	2 000	20 000
Non-Current Liabilities		
Loan – Summit Bank		40 000

	\$	\$
Total Liabilities		60 000
Owner's Equity		
Capital (opening)	80 000	
Add Net Profit	50 000	
	130 000	
Less Drawings	30 000	100 000
Total Liabilities and Owner's Equity		160 000

c. Total Assets = **\$160 000**.

Question 5

- GPM 2025 = $(\$225\,000 \div \$500\,000) \times 100 = \mathbf{45.0\%}$; GPM 2026 = $(\$208\,000 \div \$520\,000) \times 100 = \mathbf{40.0\%}$.
- NPM 2025 = $(\$75\,000 \div \$500\,000) \times 100 = \mathbf{15.0\%}$; NPM 2026 = $(\$52\,000 \div \$520\,000) \times 100 = \mathbf{10.0\%}$.
- Both margins fell by 5.0 percentage points. Because the **GPM itself fell** (45.0% → 40.0%), the fall in profitability comes from the **trading margin** — the business's cost of sales rose relative to its selling prices (or it discounted its selling prices), so it kept fewer cents of gross profit in each sales dollar. This drop in the gross margin carried straight through to the Net Profit Margin.

Question 6

- Net Sales = $\$790\,000 - \$40\,000 = \mathbf{\$750\,000}$; Gross Profit = $\$750\,000 - \$420\,000 = \mathbf{\$330\,000}$; Net Profit = $\$330\,000 - \$180\,000 = \mathbf{\$150\,000}$.
- GPM = $(\$330\,000 \div \$750\,000) \times 100 = \mathbf{44.0\%}$; NPM = $(\$150\,000 \div \$750\,000) \times 100 = \mathbf{20.0\%}$.
- The Inventory of \$70 000 is reported as a **current asset** in the Balance Sheet, because it is held to be **sold within the next 12 months** and so meets the 12-month test.

Question 7

GPM = $(\$360\,000 \div \$800\,000) \times 100 = \mathbf{45.0\%}$; NPM = $(\$96\,000 \div \$800\,000) \times 100 = \mathbf{12.0\%}$. The business keeps **45 cents of gross profit** and **12 cents of net profit** in every sales dollar; the 33-cent difference is its other expenses as a share of sales.

Question 8

Net Sales = $\$460\,000 - \$10\,000 = \$450\,000$; Gross Profit = $\$450\,000 - \$270\,000 = \$180\,000$; total expenses = $\$55\,000 + \$18\,000 + \$9\,000 + \$8\,000 = \$90\,000$; Net Profit = $\$180\,000 - \$90\,000 = \$90\,000$.

Income Statement for the year ended 30 June 2026

Fairhaven Living	\$	\$
Revenue		
Sales	460 000	
less Sales Returns	10 000	
Net Sales		450 000
less Cost of Sales		270 000
Gross Profit		180 000
less Expenses		
Wages	55 000	
Rent expense	18 000	
Advertising	9 000	

Fairhaven Living	\$	\$
Interest expense	8 000	
Total Expenses		(90 000)
Net Profit		90 000

GPM = $(\$180\,000 \div \$450\,000) \times 100 = 40.0\%$; NPM = $(\$90\,000 \div \$450\,000) \times 100 = 20.0\%$.

Question 9

The \$10 000 of the loan due within 12 months is a current liability; the \$50 000 due later is non-current. Inventory of \$52 000 is a current asset.

Balance Sheet of Pinehill Pantry as at 30 June 2026

	\$	\$
Current Assets		
Bank	6 000	
Accounts Receivable	14 000	
Inventory	52 000	
Prepaid insurance	8 000	80 000
Non-Current Assets		
Shop fittings	40 000	
Delivery vehicle	30 000	70 000
Total Assets		150 000
Current Liabilities		
Accounts Payable	15 000	
GST Clearing	5 000	
Loan – Baytown Bank (current portion)	10 000	30 000
Non-Current Liabilities		
Loan – Baytown Bank		50 000
Total Liabilities		80 000
Owner's Equity		
Capital		70 000
Total Liabilities and Owner's Equity		150 000

Total Assets = **\$150 000**.

Question 10

GPM 2025 = $(\$240\,000 \div \$600\,000) \times 100 = 40.0\%$; GPM 2026 = $(\$288\,000 \div \$720\,000) \times 100 = 40.0\%$. NPM 2025 = $(\$90\,000 \div \$600\,000) \times 100 = 15.0\%$; NPM 2026 = $(\$72\,000 \div \$720\,000) \times 100 = 10.0\%$.

The **Gross Profit Margin is unchanged** at 40.0%, so the trading margin — the gap between selling and cost prices — has held firm even as sales grew. But the **Net Profit Margin has fallen** by 5.0 points, from 15.0% to 10.0%. Since the gross margin is steady while the net margin has dropped, the cause lies in the **other expenses**: they have grown **faster than sales** (from \$150 000 to \$216 000, or from 25.0% to 30.0% of net sales), eroding the share of each sales dollar kept as net profit. The likely cause is therefore rising operating costs — for example higher wages, rent or advertising — which the business should review and bring back under control.

Question 11

Aspendale: $\text{GPM} = (\$225\,000 \div \$500\,000) \times 100 = \mathbf{45.0\%}$; $\text{NPM} = (\$50\,000 \div \$500\,000) \times 100 = \mathbf{10.0\%}$. Belmore: $\text{GPM} = (\$185\,000 \div \$500\,000) \times 100 = \mathbf{37.0\%}$; $\text{NPM} = (\$70\,000 \div \$500\,000) \times 100 = \mathbf{14.0\%}$.

Aspendale converts sales to gross profit more effectively — its GPM of 45.0% is 8.0 points above Belmore's 37.0%, so for every sales dollar it keeps 45 cents of gross profit against Belmore's 37 cents (a bigger mark-up or lower cost prices). **Belmore, however, is more profitable overall** — its NPM of 14.0% beats Aspendale's 10.0%, so it keeps 14 cents of net profit in every sales dollar against Aspendale's 10. Despite starting from a lower gross margin, Belmore controls its other expenses more tightly (they are 23.0% of sales, versus Aspendale's 35.0%), and it is the net margin, not the gross margin, that measures how much profit the owner ultimately keeps.

Question 12

- Gross Profit = Gross Profit Margin $\times$ Net Sales = $45\% \times \$400\,000 = 0.45 \times \$400\,000 = \mathbf{\$180\,000}$; Cost of Sales = Net Sales – Gross Profit = $\$400\,000 - \$180\,000 = \mathbf{\$220\,000}$.
- Net Profit = Net Profit Margin $\times$ Net Sales = $12\% \times \$600\,000 = 0.12 \times \$600\,000 = \mathbf{\$72\,000}$.
- Net Sales = Gross Profit $\div$ Gross Profit Margin = $\$150\,000 \div 0.40 = \mathbf{\$375\,000}$.

Question 13

Closing Capital = opening $\$110\,000$ + Net Profit $\$66\,000$ – Drawings $\$46\,000 = \mathbf{\$130\,000}$. Inventory of $\$68\,000$ is a current asset; the six-year loan is a non-current liability.

Balance Sheet of Westgate Wholesalers as at 30 June 2026

	\$	\$
Current Assets		
Bank	12 000	
Accounts Receivable	30 000	
Inventory	68 000	110 000
Non-Current Assets		
Equipment	50 000	
Motor vehicles	60 000	110 000
Total Assets		220 000
Current Liabilities		
Accounts Payable	22 000	
GST Clearing	8 000	30 000
Non-Current Liabilities		
Loan – Ironbark Bank		60 000
Total Liabilities		90 000
Owner's Equity		
Capital (opening)	110 000	
Add Net Profit	66 000	
	176 000	
Less Drawings	46 000	130 000
Total Liabilities and Owner's Equity		220 000

Total Assets of $\$220\,000$ equal Total Liabilities plus Owner's Equity ($\$90\,000 + \$130\,000$), so the report balances.

Question 14

$\text{GPM} = (\$200\,000 \div \$500\,000) \times 100 = \mathbf{40.0\%}$; $\text{NPM} = (\$65\,000 \div \$500\,000) \times 100 = \mathbf{13.0\%}$. Closing Capital = opening $\$90\,000$ + Net Profit $\$65\,000$ – Drawings $\$40\,000 = \mathbf{\$115\,000}$.

Owner's Equity extract — Hazelwood Homeware as at 30 June 2026

	\$	\$
Owner's Equity		
Capital (opening)		90 000
Add Net Profit		65 000
		155 000
Less Drawings		40 000
Capital (closing)		115 000

∴ closing Capital is **\$115 000** — the figure that would appear as Owner's Equity in the Balance Sheet.

Question 15

- Inventory is a current asset** because it is held for the purpose of being **sold within the next 12 months**; when it is sold it converts to cash (a cash sale) or to an account receivable that is then collected, so it meets the 12-month test for a current asset.
- A **service business has no Gross Profit Margin** because it holds **no inventory** — it earns its revenue by providing a service, not by buying and selling goods. With no Cost of Sales there is no Gross Profit line, so no gross margin can be calculated; only a Net Profit Margin applies.
- The **gap between the GPM and the NPM** is the business's **other expenses expressed as a percentage of net sales**. The GPM is what is left after cost of sales; the NPM is what is left after cost of sales *and* all other expenses; the difference between them is therefore the share of every sales dollar consumed by those other expenses (wages, rent, advertising, interest and so on).
- A **single margin means little in isolation** because there is no way to judge whether it is high or low without something to measure it against. It becomes meaningful only when **compared** — with the same business's earlier periods, with its budget, or with a similar business. A comparison is valid only when made between **like and like** (the qualitative characteristic of **comparability**): the same business over time, or businesses of a similar type and size, using the same accounting methods.

Question 16

GPM 2025 = $(\$160\,000 \div \$400\,000) \times 100 = 40.0\%$; GPM 2026 = $(\$198\,000 \div \$440\,000) \times 100 = 45.0\%$. NPM 2025 = $(\$48\,000 \div \$400\,000) \times 100 = 12.0\%$; NPM 2026 = $(\$44\,000 \div \$440\,000) \times 100 = 10.0\%$.

The two margins moved in **opposite directions**: the **GPM rose** by 5.0 points (40.0% → 45.0%) while the **NPM fell** by 2.0 points (12.0% → 10.0%). The rise in the gross margin shows the **trading margin improved** — the business either bought its inventory more cheaply or raised its selling prices, keeping more gross profit in each sales dollar. Yet the net margin still fell, which is only possible if the **other expenses rose even faster** than the improvement in gross profit. As a share of net sales those expenses climbed from 28.0% in 2025 ($\$112\,000 \div \$400\,000$) to 35.0% in 2026 ($\$154\,000 \div \$440\,000$) — a 7.0-point increase that more than swallowed the 5.0-point gain in the gross margin, leaving the business keeping fewer cents of net profit per sales dollar than before.

Question 17

Correctly, GPM = $(\$210\,000 \div \$600\,000) \times 100 = 35.0\%$ and NPM = $(\$54\,000 \div \$600\,000) \times 100 = 9.0\%$.

Action (i) would record an **inventory gain of \$18 000 that never occurred** — the cards and the count both show \$60 000 on hand, so nothing supports the extra \$18 000. **Cost of Sales is taken from the inventory cards as the goods go out**, so it is not touched by the closing figure: Gross Profit stays at \$210 000 and the **Gross Profit Margin is unchanged at 35.0%**. The fictitious gain is reported **after** Gross Profit (12A), lifting Adjusted Gross Profit to \$228 000 and Net Profit to \$72 000, so the reported NPM = $(\$72\,000 \div \$600\,000) \times 100 = 12.0\%$.

Both proposals breach the owner's ethical duty to present the reports as a **faithful representation** — complete, free from material error and neutral (without bias). Action (i) reports inventory that is **not on hand**, overstating the Inventory current asset in the Balance Sheet to \$78 000 and, through the fictitious gain, inflating Net Profit and the

Net Profit Margin; the figure is neither free from material error (the \$18 000 does not exist) nor neutral (it is chosen to flatter the loan application). Action (ii) “window dresses” the Balance Sheet by classifying a debt due next month as non-current, making the short-term position look stronger than it is. The **bank** relies on the margins to judge how profitably the business trades and on the Balance Sheet to judge whether it can meet its debts; acting on an inflated Net Profit Margin of 12.0% and the flattered position, it could advance a loan the business cannot in fact service, exposing the bank to loss and the owner to loss of trust and possible legal consequences once the true position emerges. Note that the manipulation leaves the **Gross Profit Margin untouched at 35.0%** — a net margin that climbs while the gross margin stands still is exactly the pattern a careful lender should question. The owner should **value closing Inventory at the \$60 000 actually counted and classify the loan due next month as a current liability**, reporting the true margins of 35.0% and 9.0%.

Question 18

Net Sales = \$820 000 – \$20 000 = \$800 000; Gross Profit = \$800 000 – \$440 000 = \$360 000; total expenses = \$120 000 + \$40 000 + \$24 000 + \$16 000 = \$200 000; Net Profit = \$360 000 – \$200 000 = \$160 000.

Income Statement for the year ended 30 June 2026

Rivergum Retail	\$	\$
Revenue		
Sales	820 000	
less Sales Returns	20 000	
Net Sales		800 000
less Cost of Sales		440 000
Gross Profit		360 000
less Expenses		
Wages	120 000	
Rent expense	40 000	
Advertising	24 000	
Interest expense	16 000	
Total Expenses		(200 000)
Net Profit		160 000

GPM = $(\$360\,000 \div \$800\,000) \times 100 = 45.0\%$; NPM = $(\$160\,000 \div \$800\,000) \times 100 = 20.0\%$.

Closing Capital = opening \$140 000 + Net Profit \$160 000 – Drawings \$100 000 = \$200 000. The \$20 000 current portion of the loan is a current liability and the \$90 000 balance a non-current liability; Inventory of \$80 000 is a current asset.

Balance Sheet of Rivergum Retail as at 30 June 2026

	\$	\$
Current Assets		
Bank	20 000	
Accounts Receivable	50 000	
Inventory	80 000	
Prepaid insurance	10 000	160 000
Non-Current Assets		
Shop fittings	90 000	
Motor vehicles	100 000	190 000
Total Assets		350 000
Current Liabilities		

	\$	\$
Accounts Payable	30 000	
GST Clearing	10 000	
Loan – Zenith Bank (current portion)	20 000	60 000
Non-Current Liabilities		
Loan – Zenith Bank		90 000
Total Liabilities		150 000
Owner's Equity		
Capital (opening)	140 000	
Add Net Profit	160 000	
	300 000	
Less Drawings	100 000	200 000
Total Liabilities and Owner's Equity		350 000

Total Assets of \$350 000 equal Total Liabilities plus Owner's Equity (\$150 000 + \$200 000), so the Balance Sheet balances; the year's \$160 000 net profit (a 20.0% Net Profit Margin) has lifted the owner's closing Capital to \$200 000.

Chapter 12 Reporting and managing inventory — 12D Inventory turnover and inventory management

Theory

A trading business holds inventory only so that it can be **sold**. Inventory sitting on the shelf earns nothing: it ties up cash the owner has already paid out, takes up storage space, and is exposed to theft, damage and going out of date. The faster a business can **sell and replace** its inventory, the sooner that cash comes back — with a profit added — ready to be reinvested. The financial indicator that measures this speed is **Inventory Turnover**.

Inventory Turnover measures **how fast, on average, a business sells its inventory**. It is calculated by comparing the **average level of inventory held** with the **Cost of Goods Sold** for the period, and expressing the result as a **number of days**:

$$\text{Average inventory} = \frac{\text{Opening inventory} + \text{Closing inventory}}{2}$$

$$\text{Inventory Turnover (days)} = \frac{\text{Average inventory}}{\text{Cost of Goods Sold}} \times 365$$

Three ideas sit inside this formula:

- **Average inventory** is used because the amount of inventory on hand rises and falls throughout the period. Averaging the **opening** and **closing** balances gives a single, representative figure for how much inventory the business typically held.
- **Cost of Goods Sold** is the total **cost** of the inventory that was sold during the period (the Cost of Sales figure reported in the Income Statement). Both the top and bottom of the fraction are measured at **cost**, so the comparison is fair — it is not distorted by the mark-up added in the selling price.
- **× 365** converts the fraction of a year into a **number of days**, because there are 365 days in a year. The answer is read as “*it takes, on average, this many days to sell the inventory on hand.*”

Interpreting the indicator. Because the result is a **number of days**, a **lower** number is **better**: the inventory is selling **quickly**. A business with an Inventory Turnover of **30 days** sells and replaces its entire stock roughly every month (about 12 times a year). A **higher** number of days means inventory is selling **slowly** and is sitting on the shelf for longer. It follows that:

- a **fall** in the number of days is a **favourable** movement — inventory is turning over **faster**;
- a **rise** in the number of days is an **unfavourable** movement — inventory is turning over **slower**.

Fast turnover (a low number of days) is generally a sign of good inventory management: strong demand, a well-chosen range, and cash returning quickly to be put back to work. It also reduces the risk that inventory becomes obsolete or deteriorates before it is sold. But turnover that is **too** fast can be a warning that the business is **understocking** — running out of popular lines, losing sales and disappointing customers who go elsewhere.

Slow turnover (a high number of days) ties up cash in unsold inventory, adds to storage and insurance costs, and increases the risk of goods becoming **obsolete**, going **out of date** or being **damaged or stolen** before they can be sold. It may point to **over-ordering**, **slow-moving or unpopular lines**, **over-pricing**, or **falling demand**.

What makes the indicator change? Inventory Turnover moves whenever the **average inventory held** changes, whenever the **Cost of Goods Sold** (the volume of trading) changes, or both. Selling more while holding the same average stock speeds turnover; holding more stock while selling the same amount slows it. Because two figures drive the indicator, a business interpreting a change must look at **both** — a faster turnover caused by strong extra sales is very different from a faster turnover caused only by letting stock run dangerously low.

Comparing the indicator. A single figure means little on its own. Inventory Turnover becomes useful when it is **compared** — against the **previous period** (has it improved?), against the business’s own **budget or expectations**, and against **similar businesses or an industry benchmark**. Comparisons across different types of business must be made with care: a grocer selling perishable food will turn over inventory in a handful of days, while a jeweller selling

high-value items may take many months, and neither is “managing better” simply because its number is lower. Comparing like with like — the qualitative characteristic of **comparability** — is essential.

Strategies for effective inventory management. A business does not simply watch Inventory Turnover; it takes deliberate action to keep inventory selling at a healthy pace and to protect it from loss. Common strategies, and their potential effects on performance, are:

- **A regular physical count (stocktake).** Counting the inventory actually on hand and comparing it with the recorded balance verifies the records, reveals any **inventory loss** (from theft, damage, breakage or error), and identifies **slow-moving, obsolete or near-expiry lines** that need to be cleared. Acting on this information keeps reorder decisions accurate and stops dead stock accumulating.
- **Inventory rotation.** Physically bringing **older** stock to the front so it is sold **before** newer stock (first in, first out) reduces **spoilage, deterioration and obsolescence**. It is vital for perishable or dated goods, and it lowers the inventory loss that would otherwise reduce profit.
- **Maintaining expected (optimal) inventory levels.** Forecasting demand so that the business holds **enough** stock to meet sales **without over-ordering** balances the two dangers directly: too little stock causes **stockouts and lost sales**, while too much ties up cash and invites obsolescence. This strategy targets Inventory Turnover most directly.
- **Offering a complementary range.** Stocking goods that customers buy **together** (for example, a printer alongside its cartridges, or a tent alongside pegs and a groundsheet) lifts the sales of related lines and can **speed turnover** across the range. Widening the range too far, however, risks holding slow lines that drag turnover down.
- **Efficient delivery and handling.** Careful ordering, receiving, storing and transporting of inventory minimises **damage, breakage and spoilage**, and gets stock onto the shelf **promptly** so it is available to sell. Less loss and shorter holding time both support turnover and protect profit.
- **Internal controls to prevent theft.** Restricting **access** to inventory, **separating duties** so that no one person both handles and records stock, **supervising** staff, using security measures (tagging, cameras, secure storage), and matching **deliveries to orders** all reduce **inventory loss**. Because an inventory loss is an **expense**, cutting theft directly protects profit — and keeps the recorded balances (and therefore the turnover figure) reliable.

Each strategy carries a **cost or trade-off**: security systems and stocktakes take time and money, a wider range ties up more cash, and running stock lean to speed turnover risks lost sales. Effective management weighs the **benefit** of each strategy against its **cost**.

Non-financial information. The Inventory Turnover indicator is a **financial** measure, but many of the most useful signals about inventory are **non-financial** — information **not expressed in dollars**. Examples include the **number of units sold**, the **number of units returned, damaged or spoiled**, the number of **stockouts**, **customer satisfaction and complaints**, **supplier reliability and delivery times**, the business’s **market share**, and the **environmental impact** of the stock it carries and the waste it creates. Non-financial information helps **explain why** a financial indicator moved (a rise in customer complaints may sit behind a slowing turnover), supports decisions the dollar figures alone cannot (which line to discontinue), and helps the owner **predict** future performance. Sound decision-making uses financial indicators such as Inventory Turnover **together with** relevant non-financial information.

Ethical considerations. Managing inventory well must not tip over into managing it **dishonestly**. The **physical count** underpins both the reported inventory asset and the Inventory Turnover figure, so it must be conducted honestly: **overstating** the quantity on hand to hide slow-moving stock, or to make profit and the asset look larger, breaches **faithful representation** and misleads any lender or buyer relying on the reports. Pressure to improve turnover can tempt a business to **re-label the expiry dates** of near-out-of-date goods, sell **unsafe or misrepresented** stock, or use high-pressure selling — all of which put customers at risk and damage the business’s reputation and trust. There are **social and environmental** dimensions too: how obsolete or spoiled stock is disposed of, whether over-ordering creates needless waste, and — where anti-theft surveillance is used — respecting the **privacy** and fair treatment of employees while still protecting the business’s assets. Ethical inventory management protects profit **and** the interests of customers, staff, suppliers and the wider community.

Worked examples (scaffolded)

Example 1 — calculating Inventory Turnover in days

Pinnacle Sports is a trading business. For the year ended 30 June 2025 its opening inventory was \$8 000, its closing inventory was \$12 000, and its Cost of Goods Sold was \$146 000. Calculate the average inventory and the Inventory Turnover in days, and interpret the result.

Working	Comment
Average inventory = (opening \$8 000 + closing \$12 000) ÷ 2 = \$10 000 .	The indicator uses the <i>average</i> held across the year, because inventory rises and falls; averaging the opening and closing balances gives one representative figure.
Inventory Turnover = (\$10 000 ÷ \$146 000) × 365 = 25 days .	Divide average inventory by the cost of the inventory sold, then × 365 to turn the fraction of a year into a number of days.
<i>Interpret:</i> it takes about 25 days on average to sell the inventory on hand — the business turns over its stock roughly every 25 days (about 15 times a year).	A low number of days means fast-selling inventory: cash returns quickly and there is little time for stock to become obsolete.

The calculation can be set out as a **turnover schedule**:

Year	Opening inventory \$	Closing inventory \$	Average inventory \$	Cost of Goods Sold \$	Inventory Turnover (days)
2025	8 000	12 000	10 000	146 000	25

Example 2 — interpreting a change over two years

Meadowbrook Garden Supplies reports the following. Calculate the Inventory Turnover for each year, describe the change, and explain what it suggests about the business.

Year	Opening inventory \$	Closing inventory \$	Average inventory \$	Cost of Goods Sold \$	Inventory Turnover (days)
2024	9 000	11 000	10 000	73 000	50
2025	11 000	13 000	12 000	109 500	40

Working	Comment
2024: average inventory = (\$9 000 + \$11 000) ÷ 2 = \$10 000; turnover = (\$10 000 ÷ \$73 000) × 365 = 50 days .	The base year: inventory sells, on average, every 50 days.
2025: average inventory = (\$11 000 + \$13 000) ÷ 2 = \$12 000; turnover = (\$12 000 ÷ \$109 500) × 365 = 40 days .	Both figures moved: average inventory rose <i>and</i> Cost of Goods Sold rose.
Change: turnover fell by 10 days (50 → 40) — a favourable movement; inventory now sells faster.	A fall in the number of days is favourable.
<i>Explain:</i> although the business held more stock on average (\$12 000 vs \$10 000), it sold much more (Cost of Goods Sold up from \$73 000 to \$109 500), so the extra stock was cleared faster.	The faster turnover comes from stronger sales , not from starving the business of stock — the healthy kind of improvement.

∴ *Meadowbrook's* inventory management improved in 2025: a wider, better-selling range lifted sales enough to turn over a larger average inventory 10 days faster than the year before.

Worked examples (unscaffolded)

Example 3 — calculating and interpreting against a benchmark

Coastal Cellars reports opening inventory of \$15 000, closing inventory of \$21 000 and Cost of Goods Sold of \$219 000 for the year ended 30 June 2025. The industry benchmark for a business of its type is an Inventory Turnover of 40 days. Calculate the business's Inventory Turnover and compare it with the benchmark.

Average inventory = $(\$15\,000 + \$21\,000) \div 2 = \$18\,000$. Inventory Turnover = $(\$18\,000 \div \$219\,000) \times 365 = \mathbf{30\text{ days}}$. Compared with the industry benchmark of 40 days, *Coastal Cellars* turns over its inventory **10 days faster** than the typical business in its industry — a favourable position. Its stock spends less time on the shelf, so cash returns sooner and there is less risk of goods deteriorating or going out of date before they are sold, suggesting well-judged buying and a range that matches customer demand.

∴ at **30 days** against a 40-day benchmark, *Coastal Cellars* manages its inventory better than the industry average.

Example 4 — evaluating an inventory-management decision (a trade-off)

Brightside Hardware deliberately reduced the level of inventory it carries. Last year it held opening inventory of \$13 000 and closing inventory of \$11 000 on Cost of Goods Sold of \$73 000; this year it held opening inventory of \$11 000 and closing inventory of \$5 000 on the **same** Cost of Goods Sold of \$73 000. Evaluate the decision.

Last year: average inventory = $(\$13\,000 + \$11\,000) \div 2 = \$12\,000$; turnover = $(\$12\,000 \div \$73\,000) \times 365 = \mathbf{60\text{ days}}$.
 This year: average inventory = $(\$11\,000 + \$5\,000) \div 2 = \$8\,000$; turnover = $(\$8\,000 \div \$73\,000) \times 365 = \mathbf{40\text{ days}}$.
 Turnover improved by **20 days** (60 → 40). Because Cost of Goods Sold was unchanged, the business achieved the **same sales while holding a third less stock on average** — a clear efficiency gain: less cash is tied up in inventory, storage and insurance costs fall, and the risk of obsolescence drops. However, the decision carries a real **risk**. Running stock this lean leaves little buffer, so a spike in demand or a late delivery could cause **stockouts** — lost sales and dissatisfied customers who buy elsewhere. Turnover figures alone would not reveal this; the business should watch **non-financial** signals such as the number of stockouts and customer complaints.

∴ the decision improved Inventory Turnover and freed up cash, and is justified **provided** stock does not fall so low that stockouts and lost sales outweigh the saving — a trade-off the business must monitor.

Practice questions — scaffolded

Question 1

Rivergum Furniture reports opening inventory of \$14 000, closing inventory of \$16 000 and Cost of Goods Sold of \$109 500 for the year ended 30 June 2025.

- Calculate the average inventory.
- Calculate the Inventory Turnover in days.
- Interpret the result in one sentence, stating roughly how often the business sells its inventory.

Question 2

Summit Cycles reports the following.

Year	Opening inventory \$	Closing inventory \$	Cost of Goods Sold \$
2024	5 000	7 000	54 750
2025	7 000	11 000	54 750

- Calculate the Inventory Turnover in days for each year.
- State the direction and size of the change in Inventory Turnover, and whether it is favourable or unfavourable.
- State one likely cause of the change, given that Cost of Goods Sold was the same in both years.

Question 3

Lakeside Electronics reports opening inventory of \$20 000, closing inventory of \$28 000 and Cost of Goods Sold of \$292 000 for the year ended 30 June 2025. The industry benchmark is an Inventory Turnover of 24 days.

- Calculate the Inventory Turnover in days.
- State whether the business turns over its inventory faster or slower than the benchmark, and by how many days.
- State one strategy the business could use to improve (reduce) its Inventory Turnover.

Question 4

Fernwood Bakery Supplies sells perishable baking ingredients. It reports the following.

Year	Opening inventory \$	Closing inventory \$	Cost of Goods Sold \$
2024	3 000	5 000	73 000
2025	5 000	7 000	73 000

- Calculate the Inventory Turnover in days for each year.
- Explain one effect the change in turnover could have on the business's performance, given that its goods are perishable.
- Identify one item of non-financial information the business could monitor to help manage this inventory.

Question 5

Highpoint Toys reports opening inventory of \$22 000, closing inventory of \$18 000 and Cost of Goods Sold of \$146 000 for the year ended 30 June 2025. The owner is considering managing inventory levels more tightly so that the **average** inventory held falls to \$12 000, with Cost of Goods Sold unchanged.

- Calculate the current Inventory Turnover in days.
- Calculate the Inventory Turnover in days that would result from an average inventory of \$12 000.
- Discuss one benefit and one risk of holding less inventory.

Question 6

Delta Hardware reports opening inventory of \$9 000, closing inventory of \$11 000 and Cost of Goods Sold of \$91 250 for the year ended 30 June 2025. A recent physical count found the inventory on hand was \$600 **less** than the recorded balance.

- Calculate the Inventory Turnover in days.
- Explain how conducting a regular physical count helps the business manage its inventory.
- State one internal control the business could use to reduce the risk of inventory theft.

Practice questions — unscaffolded

Question 7

Brookfield Stationery reports opening inventory of \$4 000, closing inventory of \$6 000 and Cost of Goods Sold of \$73 000 for the year ended 30 June 2025. Calculate the average inventory and the Inventory Turnover in days.

Question 8

Terrace Tiles reports opening inventory of \$30 000, closing inventory of \$42 000 and Cost of Goods Sold of \$219 000 for the year ended 30 June 2025. The industry benchmark is 45 days. Calculate the Inventory Turnover in days and state whether the business is faster or slower than the benchmark, and by how much.

Question 9

Grove Cafe Wholesalers reports opening inventory of \$7 000 and closing inventory of \$9 000 on Cost of Goods Sold of \$146 000 in 2024, and opening inventory of \$9 000 and closing inventory of \$15 000 on Cost of Goods Sold of \$146 000 in 2025. Calculate the Inventory Turnover for each year, describe the change, and state one likely cause and one effect on performance.

Question 10

Ridgeway Appliances reports an Inventory Turnover of 45 days on Cost of Goods Sold of \$73 000 for the year ended 30 June 2025. Its opening inventory was \$7 000. Calculate the average inventory the business must have held, and hence its closing inventory.

Question 11

Two businesses report for the year ended 30 June 2025:

- *Metro Grocers* (a supermarket) — opening inventory \$8 000, closing inventory \$12 000, Cost of Goods Sold \$365 000.
- *Crown Jewellers* (a jewellery retailer) — opening inventory \$40 000, closing inventory \$60 000, Cost of Goods Sold \$182 500.

Calculate the Inventory Turnover for each business, then discuss whether it is fair to conclude that Metro Grocers “manages its inventory better” because it turns over faster.

Question 12

Sunrise Dairy Distributors sells perishable dairy products and reports opening inventory of \$5 000, closing inventory of \$7 000 and Cost of Goods Sold of \$219 000 for the year ended 30 June 2025. Calculate the Inventory Turnover, then evaluate the strategy of **inventory rotation** for this business, referring to its likely effect on inventory loss and performance, and to one item of non-financial information the business could monitor.

Question 13

Ironbark Outdoors introduced a **complementary range** (adding gas canisters, cookware and repair kits alongside its camping stoves). Before the change it reported opening inventory of \$22 000, closing inventory of \$28 000 and Cost of Goods Sold of \$182 500; after the change it reported opening inventory of \$24 000, closing inventory of \$30 000 and Cost of Goods Sold of \$219 000. Calculate the Inventory Turnover before and after, and evaluate the decision to introduce the complementary range.

Question 14

Portside Ceramics sells fragile homewares and reports opening inventory of \$7 000, closing inventory of \$9 000 and Cost of Goods Sold of \$58 400 for the year ended 30 June 2025. After introducing more careful delivery and handling procedures, its annual inventory loss from breakage fell from \$1 200 to \$300. Calculate the Inventory Turnover, and evaluate the strategy of improving delivery and handling, referring to its effect on performance.

Question 15

Cobalt Electronics reports opening inventory of \$18 000, closing inventory of \$22 000 and Cost of Goods Sold of \$146 000 for the year ended 30 June 2025. A physical count found the inventory on hand was \$2 000 **below** the recorded balance, which the owner suspects is due to theft. Calculate the Inventory Turnover, then evaluate the use of internal controls to prevent theft, referring to their effect on performance and to the role of the physical count.

Question 16

A business owner argues that, because fast Inventory Turnover is favourable, the business should aim to hold **as little inventory as possible** at all times. Discuss this view, referring to the trade-offs involved.

Question 17

Explain the role of **non-financial information** in managing inventory and assessing a trading business’s performance. Refer to at least two examples of non-financial information and explain how each could be used alongside the Inventory Turnover indicator.

Question 18

The manager of *Northwind Health Foods*, under pressure from the owner to improve the store’s Inventory Turnover, instructs staff to **re-label near-expiry products with later best-before dates** and to record the annual physical count at **inflated quantities** so that slow-moving lines are hidden. Discuss the effect these actions would have on the reported Inventory Turnover and on the business’s stakeholders, with reference to a relevant ethical consideration.

Answers

1.
 - a. \$15 000 b. 50 days c. Sells its inventory on average every 50 days (about 7 times a year).
2.
 - a. 2024 **40 days**; 2025 **60 days**. b. Rose by 20 days (40 → 60) — unfavourable. c. A higher average inventory held (over-ordering / slower-selling stock), since Cost of Goods Sold was unchanged.
3.
 - a. **30 days** b. Slower than the benchmark, by 6 days. c. e.g. reduce the average inventory held / clear slow-moving lines / maintain expected levels.
4.
 - a. 2024 **20 days**; 2025 **30 days**. b. Slower turnover means perishable stock sits longer, raising the risk of spoilage and inventory loss. c. e.g. number of units spoiled or discarded.
5.
 - a. **50 days** b. **30 days** c. See solutions (benefit: less cash tied up / lower holding and obsolescence risk; risk: stockouts and lost sales).
6.
 - a. **40 days** b–c. See solutions.
7. Average inventory \$5 000; Inventory Turnover **25 days**.
8. **60 days** — slower than the 45-day benchmark, by 15 days.
9. 2024 **20 days**; 2025 **30 days** (slower by 10). See solutions.
10. Average inventory **\$9 000**; closing inventory **\$11 000**.
11. Metro Grocers **10 days**; Crown Jewellers **100 days**. See solutions (not a fair conclusion — comparability).
12. **10 days**. See solutions.
13. Before **50 days**; after **45 days** (faster by 5). See solutions.
14. **50 days**. See solutions.
15. **50 days**. See solutions.
16. Discuss — see solutions.
17. Discuss — see solutions.
18. Discuss — see solutions.

Fully-worked solutions

Question 1

- a. Average inventory = (opening \$14 000 + closing \$16 000) ÷ 2 = **\$15 000**.
- b. Inventory Turnover = (\$15 000 ÷ \$109 500) × 365 = **50 days**.
- c. On average it takes about 50 days to sell the inventory on hand, so the business turns over (sells and replaces) its entire inventory roughly every 50 days — about 7 times a year.

Question 2

Year	Average inventory \$	Cost of Goods Sold \$	Inventory Turnover (days)
2024	6 000	54 750	40
2025	9 000	54 750	60

2024: average inventory = (\$5 000 + \$7 000) ÷ 2 = \$6 000; turnover = (\$6 000 ÷ \$54 750) × 365 = **40 days**. 2025: average inventory = (\$7 000 + \$11 000) ÷ 2 = \$9 000; turnover = (\$9 000 ÷ \$54 750) × 365 = **60 days**.

- b. Inventory Turnover **rose by 20 days** (40 → 60). Because the number of days *increased*, the movement is **unfavourable** — inventory is now selling more slowly.
- c. With Cost of Goods Sold unchanged, the slowdown must be due to the **higher average inventory held** (\$9 000 vs \$6 000) — the business over-ordered or is carrying slower-selling stock, so the same volume of sales now clears a larger stockpile, taking longer.

Question 3

- a. Average inventory = $(\$20\,000 + \$28\,000) \div 2 = \$24\,000$; Inventory Turnover = $(\$24\,000 \div \$292\,000) \times 365 = \mathbf{30\ days}$.
- b. At 30 days the business is **slower** than the 24-day benchmark, by **6 days** — its inventory sits on the shelf 6 days longer than the typical business in its industry.
- c. Any one of: reduce the average inventory held to better match sales; clear or discontinue slow-moving lines identified at the physical count; maintain expected (optimal) inventory levels through better demand forecasting.

Question 4

- a. 2024: average inventory = $(\$3\,000 + \$5\,000) \div 2 = \$4\,000$; turnover = $(\$4\,000 \div \$73\,000) \times 365 = \mathbf{20\ days}$.
2025: average inventory = $(\$5\,000 + \$7\,000) \div 2 = \$6\,000$; turnover = $(\$6\,000 \div \$73\,000) \times 365 = \mathbf{30\ days}$.
Turnover **rose by 10 days** (slower).
- b. Because the goods are **perishable**, slower turnover means stock now sits for about 10 extra days before it is sold — increasing the risk that it **spoil or passes its use-by date** and must be written off as an **inventory loss**, which raises expenses and reduces profit. Cash is also tied up in stock for longer.
- c. Any one of: the number of units spoiled, discarded or written off; the number of units approaching their use-by date; customer complaints about freshness.

Question 5

- a. Average inventory = $(\$22\,000 + \$18\,000) \div 2 = \$20\,000$; Inventory Turnover = $(\$20\,000 \div \$146\,000) \times 365 = \mathbf{50\ days}$.
- b. With average inventory of \$12 000 and Cost of Goods Sold unchanged: Inventory Turnover = $(\$12\,000 \div \$146\,000) \times 365 = \mathbf{30\ days}$ — an improvement of 20 days.
- c. **Benefit:** holding less inventory frees up **cash** that was tied up in stock (which can be used elsewhere or reduce borrowing), and lowers storage, insurance and obsolescence costs, so turnover speeds to 30 days. **Risk:** carrying less stock leaves a smaller buffer, so a surge in demand or a delayed delivery could cause **stockouts** — the business loses sales and disappoints customers, who may take their custom elsewhere. The owner must set inventory at a level that speeds turnover **without** running out of popular lines.

Question 6

- a. Average inventory = $(\$9\,000 + \$11\,000) \div 2 = \$10\,000$; Inventory Turnover = $(\$10\,000 \div \$91\,250) \times 365 = \mathbf{40\ days}$.
- b. A regular **physical count** compares the inventory actually on hand with the recorded balance. It verifies the accuracy of the records, reveals any **inventory loss** (here \$600, pointing to theft, damage or error), and identifies **slow-moving or obsolete lines** that should be cleared. Acting on this information keeps reorder decisions accurate and stops dead or missing stock from distorting the reports and the turnover figure.
- c. Any one of: restrict access to the storage area; separate the duties of handling and recording inventory; supervise staff; install security measures such as cameras or tagging; check deliveries against orders.

Question 7

Average inventory = $(\text{opening } \$4\,000 + \text{closing } \$6\,000) \div 2 = \mathbf{\$5\,000}$. Inventory Turnover = $(\$5\,000 \div \$73\,000) \times 365 = \mathbf{25\ days}$.

Question 8

Average inventory = $(\$30\,000 + \$42\,000) \div 2 = \$36\,000$; Inventory Turnover = $(\$36\,000 \div \$219\,000) \times 365 = \mathbf{60\ days}$. At 60 days the business is **slower** than the 45-day benchmark, by **15 days** — its inventory takes 15 days longer to sell than the typical business in its industry, an unfavourable position that ties up cash and raises the risk of stock becoming obsolete.

Question 9

2024: average inventory = $(\$7\,000 + \$9\,000) \div 2 = \$8\,000$; turnover = $(\$8\,000 \div \$146\,000) \times 365 = \mathbf{20\ days}$. 2025: average inventory = $(\$9\,000 + \$15\,000) \div 2 = \$12\,000$; turnover = $(\$12\,000 \div \$146\,000) \times 365 = \mathbf{30\ days}$. Inventory Turnover **rose by 10 days** (slower) — an unfavourable movement. With Cost of Goods Sold unchanged, the cause is the **higher average inventory held** (\$12 000 vs \$8 000): the business over-ordered or built up slower-selling stock. One effect on performance is that more cash is now tied up in inventory for longer, raising storage costs and the risk of obsolescence, and weakening the business's liquidity.

Question 10

Rearranging the formula, average inventory = $\text{Inventory Turnover} \times \text{Cost of Goods Sold} \div 365 = 45 \times \$73\,000 \div 365 = \mathbf{\$9\,000}$. Since average inventory = $(\text{opening} + \text{closing}) \div 2$, closing inventory = $(2 \times \$9\,000) - \text{opening } \$7\,000 = \$18\,000 - \$7\,000 = \mathbf{\$11\,000}$.

Question 11

Metro Grocers: average inventory = $(\$8\,000 + \$12\,000) \div 2 = \$10\,000$; Inventory Turnover = $(\$10\,000 \div \$365\,000) \times 365 = \mathbf{10\ days}$. *Crown Jewellers*: average inventory = $(\$40\,000 + \$60\,000) \div 2 = \$50\,000$; Inventory Turnover = $(\$50\,000 \div \$182\,500) \times 365 = \mathbf{100\ days}$.

It is **not fair** to conclude from these figures alone that Metro Grocers manages its inventory better. The two businesses are in **very different industries**: a supermarket sells fast-moving, perishable, low-value groceries that *must* turn over in days, while a jeweller sells high-value, non-perishable items that customers buy infrequently, so a much longer turnover is entirely normal. Comparing their raw turnover figures breaches the qualitative characteristic of **comparability** — like is not being compared with like. Each business should instead be judged against **its own** past figures, budget and **industry benchmark**. Crown Jewellers turning over in 100 days may be excellent *for a jeweller*, just as Metro's 10 days is expected *for a grocer*.

Question 12

Average inventory = $(\$5\,000 + \$7\,000) \div 2 = \$6\,000$; Inventory Turnover = $(\$6\,000 \div \$219\,000) \times 365 = \mathbf{10\ days}$. For a business selling **perishable** dairy products, a 10-day turnover is essential, and **inventory rotation** directly supports it: by physically moving **older** stock to the front so it sells **before** newer stock, the business ensures products are sold well within their use-by dates. This **reduces spoilage and the resulting inventory loss**, protecting gross profit, and it keeps customers supplied with fresh product, supporting sales and the fast turnover. The cost of the strategy is small (staff time to rotate the shelves), so the benefit clearly outweighs it. A useful item of **non-financial information** to monitor is the **number of units discarded or written off due to spoilage** (or the number of customer complaints about freshness), which shows whether the rotation is working.

Question 13

Before: average inventory = $(\$22\,000 + \$28\,000) \div 2 = \$25\,000$; Inventory Turnover = $(\$25\,000 \div \$182\,500) \times 365 = \mathbf{50\ days}$. After: average inventory = $(\$24\,000 + \$30\,000) \div 2 = \$27\,000$; Inventory Turnover = $(\$27\,000 \div \$219\,000) \times 365 = \mathbf{45\ days}$.

The **complementary range** was a sound decision. Adding goods that customers buy **together** with the camping stoves lifted total sales (Cost of Goods Sold rose from \$182 500 to \$219 000), and even though the business held **more** stock on average (\$27 000 vs \$25 000), turnover still **improved by 5 days** (50 → 45) because the extra stock sold quickly as part of the range. Faster turnover with higher sales strengthens both profit and liquidity. The main **risk** to weigh is that widening the range too far could leave the business holding slow-moving lines that tie up cash and drag turnover back down, so the business should keep monitoring which lines actually sell. On the evidence here — higher sales *and* faster turnover — the strategy is justified.

Question 14

Average inventory = $(\$7\,000 + \$9\,000) \div 2 = \$8\,000$; Inventory Turnover = $(\$8\,000 \div \$58\,400) \times 365 = \mathbf{50\ days}$. For a business selling **fragile** goods, more careful **delivery and handling** is worthwhile: it cut the inventory loss from breakage from \$1 200 to \$300, a **\$900 saving** that reduces expenses and directly **raises profit**. Less breakage also means more saleable stock reaches the shelf and stock is available sooner, supporting sales and turnover. The strategy

does have a **cost** (more careful — and possibly slower or dearer — handling and packaging), but a \$900 reduction in losses comfortably outweighs the modest extra effort, so the decision improves performance and is justified. The business could track the **number of items damaged in transit or handling** as a non-financial check that the new procedures are working.

Question 15

Average inventory = $(\$18\,000 + \$22\,000) \div 2 = \$20\,000$; Inventory Turnover = $(\$20\,000 \div \$146\,000) \times 365 = 50$ days. The **\$2 000 shortfall** found at the physical count is an **inventory loss** that reduces profit, so **internal controls to prevent theft** — restricting access to stock, separating the duties of handling and recording inventory, supervising staff, and using security measures such as cameras or tagging — are worthwhile: by cutting theft they reduce the inventory-loss expense, **protect profit**, and keep the recorded balances (and therefore the turnover figure) reliable. These controls carry a **cost** (security systems, staff time, and care not to damage staff trust or privacy through heavy-handed surveillance), which the business must weigh against the losses prevented. The **physical count** is central to the strategy: it is what **reveals** the loss in the first place and measures whether the controls are reducing it over time, so the count and the controls work together.

Question 16

The owner is right that a **low** number of days (fast turnover) is generally favourable — cash returns quickly, less is tied up in stock, and there is less risk of obsolescence. But aiming to hold **as little inventory as possible** ignores the **trade-off** on the other side. Too little stock causes **stockouts**: the business runs out of popular lines, **loses sales**, and disappoints customers, who may switch to competitors and not return — harming both current profit and the business's reputation. It also leaves no buffer for surges in demand, late supplier deliveries or seasonal peaks. The goal is therefore **not** the minimum possible inventory but the **optimal (expected) level** — enough to meet expected demand reliably **without** over-ordering. Effective management balances **fast turnover** against **reliable supply**, using demand forecasts and non-financial signals (such as the number of stockouts and customer complaints) to find the level that serves customers well while keeping stock moving.

Question 17

Non-financial information is information **not expressed in dollars**. It plays an important role in managing inventory and assessing performance because financial indicators such as Inventory Turnover tell the owner **what** happened but not always **why**, and they cannot capture everything that matters to the business's future. Used **alongside** the financial figures, non-financial information gives a fuller picture and supports better decisions. For example:

- The **number of units spoiled, damaged or returned** helps explain a slowing Inventory Turnover — if turnover has risen (slowed) and spoilage is also climbing, the business knows the problem is ageing or poor-quality stock and can respond with better rotation or a smaller order.
- **Customer satisfaction and complaints** (or the number of **stockouts**) reveals whether fast turnover has been achieved at the customer's expense — a very low turnover figure looks good on paper but, paired with frequent stockouts and complaints, warns that the business is understocking and losing sales.

Other examples include supplier reliability and delivery times, market share, and the environmental impact of the stock carried. By reading these signals **together with** Inventory Turnover, the owner can judge not only how fast inventory is selling but whether it is being managed in a way that is **sustainable** and keeps customers coming back.

Question 18

Both instructions are designed to make Inventory Turnover look better than it truly is. **Re-labelling near-expiry products with later dates** keeps stock that should be cleared or written off sitting in the records as saleable, while **recording the physical count at inflated quantities** overstates the closing inventory. A higher closing inventory raises the **average inventory**, which would actually *worsen* the calculated turnover — but more seriously, the reported inventory figure and profit no longer reflect reality: an overstated count **overstates the Inventory asset and profit**, and hides the slow-moving lines that management should be acting on.

These actions breach **faithful representation**: the physical count and the reports must be **complete, free from material error** and **neutral (without bias)**, presenting the business's real position rather than a flattering one. An inflated count is a **material error** — the recorded quantity does not depict what is genuinely on hand — and, because

it is chosen deliberately to make turnover look better, it is not **neutral** either. Stakeholders are harmed on several fronts. **Customers** are exposed to **out-of-date and potentially unsafe** food, a serious ethical and safety failure. The **owner** and any **lender or prospective buyer** relying on the reports are misled about the value of inventory and the true profit, and may make decisions they would not make if they knew the real position. **Staff** are placed in the position of carrying out dishonest instructions. When the deception is discovered — through a health inspection, a customer complaint or an audit — the business faces loss of customer trust, reputational damage and possible legal consequences. The ethical course is to **count and report inventory honestly**, clear or write off genuinely slow-moving and expired stock, and improve turnover through legitimate management strategies rather than by disguising the figures.

Topic 3 Test A — Recording and analysis

Reading time: 10 minutes · Writing time: 50 minutes · 50 marks · A scientific calculator may be used.

This test is cumulative over Chapters 11–12: trading firms and inventory, inventory cards on a **First-In, First-Out (FIFO)** or **Identified Cost** basis, the physical count, Cost of Sales, the trading Income Statement and classified Balance Sheet, the profitability indicators and Inventory Turnover. Each business is registered for GST and uses the perpetual inventory system; GST is 10% (1/11 of a GST-inclusive amount). Prepare inventory cards with three cost columns (Qty, Cost, Total) under each of IN, OUT and BALANCE.

Question 1 (13 marks)

Sorrento Surf Co sells the *Breaker* bodyboard and values it on a **FIFO** basis. The following relate to the *Breaker* bodyboard for October 2025.

- **1 Oct** — opening balance: 8 boards at \$45 each.
- **4 Oct** — purchased 22 boards on credit at \$50 each (**Invoice 612**).
- **13 Oct** — sold 24 boards at \$95 each, plus GST (**Invoice S30**).
- **18 Oct** — a customer returned 3 of the boards sold on 13 October (**Credit Note 21**).
- **31 Oct** — a physical count of the *Breaker* boards found 8 on hand (**Memo 9**).

- a. Complete the inventory card for the *Breaker* bodyboard for October. 7 marks
- b. State the Cost of Sales for October (net of the sales return). 2 marks
- c. Prepare the trading section of the Income Statement for the month ended 31 October 2025, down to Adjusted Gross Profit. 4 marks

Question 2 (9 marks)

Aramoana Appliances and *Brighton Reef Appliances* each began the period holding 6 *Vero* ovens at \$400 and each then bought 9 more at \$460 (**Invoice 720**) — cost prices are rising. During the period each business sold 11 *Vero* ovens for the **same** total sales revenue of \$8 250 (plus GST). *Aramoana Appliances* uses **Identified Cost** and identifies 3 of the \$400 ovens and 8 of the \$460 ovens as the units sold; *Brighton Reef Appliances* uses **FIFO**.

- a. Calculate each business's Cost of Sales on these ovens. 3 marks
- b. Model the effect of each business's cost-assignment method on its gross profit on these ovens, and state which business reports the higher gross profit and by how much. 3 marks
- c. Explain, with reference to the discretion each method allows, why the two businesses report a different gross profit even though the goods traded are identical. 3 marks

Question 3 (8 marks)

Delacombe Timber & Hardware provides the following for two years. Its Cost of Goods Sold was \$219 000 in **both** years.

Year	Opening inventory \$	Closing inventory \$	Cost of Goods Sold \$
2025	24 000	30 000	219 000
2026	30 000	42 000	219 000

- a. Calculate the Inventory Turnover in days for each year (show the average inventory used). 4 marks
- b. State the direction and size of the change in Inventory Turnover and whether it is favourable or unfavourable. 2 marks
- c. Cost of Goods Sold was unchanged, yet turnover moved. Discuss the likely cause and **one** inventory-management strategy the business could use to improve its turnover. 2 marks

Question 4 (12 marks)

Terang Traders (owner M. Terang) is a trading business. For the year ended 30 June 2026 its Net Sales were \$650 000, its Cost of Sales \$390 000 and its other expenses totalled \$130 000 (giving a Net Profit of \$130 000). At 30 June 2026 the business had:

Item	\$
Bank	16 000
Accounts Receivable	38 000
Inventory	56 000
Prepaid insurance	6 000
Shop fittings	70 000
Delivery vehicle	54 000
Accounts Payable	26 000
GST Clearing	8 000
Loan – Otway Finance	80 000

The Loan – Otway Finance is repayable \$15 000 within the next 12 months and \$65 000 beyond. The owner's Capital was \$120 000 at 1 July 2025 and the owner took \$124 000 of drawings during the year.

- Calculate the Gross Profit Margin and the Net Profit Margin for the year. 3 marks
- Prepare the classified Balance Sheet as at 30 June 2026, showing the net profit and drawings in the Owner's Equity section and the loan split across current and non-current liabilities. 8 marks
- State where Inventory is reported in the Balance Sheet and explain in one sentence why it is a current asset. 1 mark

Question 5 (8 marks)

Nullarbor Furniture is a trading business being prepared for sale. For the year ended 30 June 2026 its Net Sales were \$300 000 and its Cost of Sales \$180 000. The physical count on 30 June revealed an **inventory loss of \$3 000** (stock shrinkage) on the discontinued sofa range. To present a stronger result to a prospective buyer, the owner proposes to record **no inventory loss** at all, and to put through an **inventory gain of \$3 000** on the dining range that the count did not find, "to balance the sofas out".

- Calculate the correct Gross Profit and the correct Adjusted Gross Profit. 2 marks
- Calculate the "Adjusted Gross Profit" the owner's proposal would report, and state by how much it overstates the true result. 2 marks
- Discuss the ethical considerations raised by the owner's proposal, referring to a relevant qualitative characteristic and to the effect on the buyer and on the Inventory reported in the Balance Sheet. 4 marks

Topic 3 Test A — solutions

Question 1 (13 marks)

a. The sale of 24 boards on 13 October draws first on the 8 boards at \$45 (\$360), then on 16 of the boards at \$50 (\$800). The sales return on 18 October reverses the **last** units taken out — 3 boards at \$50 (\$150) brought back IN. The count of 8 against a recorded 9 is an inventory **loss** of 1 board, valued at the oldest cost on hand (\$50).

Inventory Card — Breaker bodyboard (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Oct	Balance							8	45	360
4 Oct	Inv. 612	22	50	1100				8	45	360
								22	50	1100
13 Oct	Inv. S30				8	45	360	6	50	300
					16	50	800			
18 Oct	CN 21 (sales return)	3	50	150				9	50	450
31 Oct	Memo 9 (loss)				1	50	50	8	50	400

b. Cost of the 13 October sale = \$360 + \$800 = \$1 160; less the sales return brought back in (3 @ \$50 = \$150). **Cost of Sales = \$1 160 – \$150 = \$1 010.**

c. Sales = 24 @ \$95 = \$2 280; Sales Returns = 3 @ \$95 = \$285, so Net Sales = **\$1 995**. Gross Profit = \$1 995 – \$1 010 = **\$985**; the inventory loss of \$50 is deducted to give an Adjusted Gross Profit of **\$935**.

Income Statement (extract) for the month ended 31 October 2025

Sorrento Surf Co	\$	\$
Revenue		
Sales	2 280	
less Sales Returns	(285)	
Net Sales		1 995
less Cost of Sales		(1 010)
Gross Profit		985
less Inventory loss		(50)
Adjusted Gross Profit		935

Question 2 (9 marks)

a. *Aramoana Appliances* (Identified Cost): 3 @ \$400 + 8 @ \$460 = \$1 200 + \$3 680 = **\$4 880**. *Brighton Reef Appliances* (FIFO — oldest first): 6 @ \$400 + 5 @ \$460 = \$2 400 + \$2 300 = **\$4 700**.

b. Because the sales revenue is identical (\$8 250), a **lower** Cost of Sales gives a **higher** gross profit. Aramoana's gross profit = \$8 250 – \$4 880 = **\$3 370**; Brighton Reef's = \$8 250 – \$4 700 = **\$3 550**. **Brighton Reef (FIFO) reports the higher gross profit — by \$180** (the same \$180 by which its Cost of Sales is lower).

c. Both businesses bought the identical ovens (6 @ \$400 and 9 @ \$460) and sold the same 11 units for the same revenue, yet they assign a **different cost** to the units sold. **FIFO** applies one fixed rule — the oldest cost prices are cleared first — so Brighton Reef *must* charge the six \$400 ovens and five \$460 ovens to Cost of Sales. **Identified**

Cost gives management the **discretion** to nominate *which* specific units were sold; Aramoana chose to identify more of the dearer \$460 ovens (eight of them), lifting its Cost of Sales and lowering its gross profit. Because gross profit = sales – cost of sales and the sales are the same, the method that assigns the higher cost of sales reports the lower gross profit — here the difference is entirely a product of the cost-assignment method, not of any difference in the goods traded.

Question 3 (8 marks)

a. Average inventory = (opening + closing) ÷ 2; Inventory Turnover = (average inventory ÷ Cost of Goods Sold) × 365.

Year	Average inventory \$	Cost of Goods Sold \$	Inventory Turnover (days)
2025	27 000	219 000	45
2026	36 000	219 000	60

2025: average inventory = (\$24 000 + \$30 000) ÷ 2 = \$27 000; turnover = (\$27 000 ÷ \$219 000) × 365 = **45 days**.

2026: average inventory = (\$30 000 + \$42 000) ÷ 2 = \$36 000; turnover = (\$36 000 ÷ \$219 000) × 365 = **60 days**.

b. Inventory Turnover **rose by 15 days** (45 → 60). Because the number of days *increased*, the movement is **unfavourable** — inventory is now selling more slowly.

c. With Cost of Goods Sold unchanged at \$219 000, the slowdown must be driven by the **higher average inventory held** (\$36 000 vs \$27 000): the business has over-ordered or is carrying slower-moving lines, so the same volume of sales now has to clear a larger stockpile, taking longer and tying up more cash. To improve (reduce) its turnover the business could **maintain expected (optimal) inventory levels** — forecasting demand so it holds enough stock to meet sales without over-ordering — and use a **regular physical count** to identify and clear slow-moving or obsolete lines. (Other acceptable strategies: inventory rotation; a complementary range to lift sales of related lines.)

Question 4 (12 marks)

a. Gross Profit = \$650 000 – \$390 000 = \$260 000. Gross Profit Margin = (\$260 000 ÷ \$650 000) × 100 = **40.0%**. Net Profit Margin = (\$130 000 ÷ \$650 000) × 100 = **20.0%**.

b. Closing Capital = opening \$120 000 + Net Profit \$130 000 – Drawings \$124 000 = **\$126 000**. The \$15 000 current portion of the loan is a current liability and the \$65 000 balance a non-current liability; Inventory of \$56 000 is a current asset.

Balance Sheet of Terang Traders as at 30 June 2026

	\$	\$
Current Assets		
Bank	16 000	
Accounts Receivable	38 000	
Inventory	56 000	
Prepaid insurance	6 000	116 000
Non-Current Assets		
Shop fittings	70 000	
Delivery vehicle	54 000	124 000
Total Assets		240 000
Current Liabilities		
Accounts Payable	26 000	
GST Clearing	8 000	
Loan – Otway Finance (current portion)	15 000	49 000
Non-Current Liabilities		

	\$	\$
Loan – Otway Finance		65 000
Total Liabilities		114 000
Owner's Equity		
Capital (opening)	120 000	
Add Net Profit	130 000	
	250 000	
Less Drawings	124 000	126 000
Total Liabilities and Owner's Equity		240 000

Total Assets of \$240 000 equal Total Liabilities plus Owner's Equity (\$114 000 + \$126 000), so the report balances.

c. Inventory of \$56 000 is reported among the **Current Assets**. It is a current asset because it is held to be **sold within the next 12 months**, converting it to cash (a cash sale) or to an account receivable, so it meets the 12-month test.

Question 5 (8 marks)

a. Gross Profit = \$300 000 – \$180 000 = **\$120 000**. The only adjustment the count actually supports is the \$3 000 inventory loss, so the correct Adjusted Gross Profit = \$120 000 – \$3 000 = **\$117 000**.

b. Omitting the loss and adding an unsupported \$3 000 gain would report an Adjusted Gross Profit of \$120 000 + \$3 000 = **\$123 000, overstating** the true result of \$117 000 by **\$6 000**.

c. The proposal breaches the owner's ethical duty to present the reports as a **faithful representation** — information that is **complete, free from material error** and **neutral (without bias)**. It fails on all three limbs: leaving out the \$3 000 shrinkage makes the report incomplete; adding a \$3 000 gain the count never found puts a material error into the reports; and both changes are made precisely to flatter the result for the sale, so the reports are not neutral. The physical count — not the owner's preference — is the evidence of what is on hand: a shortfall must be recorded as an inventory loss, and a gain may only be recorded where the count actually finds one. The proposal also destroys the **relevance** of the reports for the buyer's decision: a buyer valuing the business on a \$123 000 Adjusted Gross Profit — and on an **Inventory current asset overstated by \$6 000** in the Balance Sheet (\$3 000 of missing stock plus \$3 000 of stock that never existed) — would **overpay** for trading performance and inventory the business does not have, and the overstatement would be exposed at the first count after settlement. The ethical course is to record the \$3 000 loss, record no gain, and present the genuine Adjusted Gross Profit of \$117 000, so the buyer can make an informed decision.

Topic 3 Test B — Short-answer recording

Reading time: 10 minutes · Writing time: 45 minutes · 40 marks · A scientific calculator may be used.

This test is cumulative over Chapters 11–12. Each business is registered for GST and uses the perpetual inventory system; GST is 10% (1/11 of a GST-inclusive amount), recorded through the **GST Clearing** account. Inventory losses and gains, drawings of inventory and inventory used for advertising carry no GST. Prepare inventory cards with three cost columns (Qty, Cost, Total) under each of IN, OUT and BALANCE.

Question 1 (7 marks)

Marong Auto Parts sells the *Vortex* brake pad set and values it on a **FIFO** basis. The following relate to the *Vortex* brake pad set for May 2026.

- **1 May** — opening balance: 10 sets at \$28 each.
- **4 May** — purchased 20 sets on credit at \$32 each (**Invoice 410**).
- **9 May** — returned 4 sets to the supplier (**Credit Note 18**).
- **17 May** — sold 18 sets (**Invoice S52**).

- a. Complete the inventory card for the *Vortex* brake pad set for May. 5 marks
- b. State the Cost of Sales for the sale on 17 May. 1 mark
- c. State the value of closing inventory at 31 May. 1 mark

Question 2 (6 marks)

Tarra Valley Jewellers sells the *Aurora* pendant and values it on an **Identified Cost** basis (each pendant is individually tagged with its cost). The following relate to the *Aurora* pendant for June 2026.

- **1 Jun** — opening balance: 4 pendants at \$120 each.
- **6 Jun** — purchased 8 pendants on credit at \$140 each (**Invoice 305**).
- **15 Jun** — sold 7 pendants, identified as 2 of the \$120 pendants and 5 of the \$140 pendants (**Invoice S40**).
- **30 Jun** — a physical count found 4 pendants on hand; the missing pendant is identified as a \$140 pendant (**Memo 7**).

- a. Complete the inventory card for the *Aurora* pendant for June. 4 marks
- b. State the Cost of Sales for the sale on 15 June. 1 mark
- c. State the value of the inventory loss. 1 mark

Question 3 (6 marks)

Ouyen Provisions is registered for GST and records GST through the **GST Clearing** account.

- a. It made a cash sale of inventory for \$5 610 including GST (**Rec. 88**). Calculate the GST and the amount recorded as Sales. 2 marks
- b. It bought inventory on credit for \$3 300 including GST (**Invoice 512**). Calculate the GST and the amount recorded as Inventory. 2 marks
- c. State the account used to record the GST on these transactions and whether its balance is usually a current asset or a current liability for a trading firm. 2 marks

Question 4 (7 marks)

Boort Building Supplies provides the following for the year ended 30 June 2026: opening inventory \$14 000; purchases \$92 000; purchase returns \$4 000; closing inventory \$18 000; sales \$150 000; and sales returns \$6 000. No inventory was lost, taken as drawings or used for advertising.

- a. Calculate Net Purchases. 1 mark

- b. Prepare a schedule computing the Cost of Sales. 3 marks
- c. Calculate the Net Sales and the Gross Profit. 3 marks

Question 5 (6 marks)

Nhill Fasteners provides the following for the year ended 30 June 2026: opening inventory \$9 000; purchases \$61 000 (no purchase returns); closing inventory (per the count) \$11 500; and an inventory loss of \$500 recorded during the year (no drawings or advertising of inventory). Sales were \$96 000 with no sales returns.

- a. Calculate the Cost of Sales, taking care to separate the inventory loss. 3 marks
- b. Calculate the Gross Profit and the Adjusted Gross Profit. 2 marks
- c. Explain in one sentence why the inventory loss is not part of Cost of Sales. 1 mark

Question 6 (4 marks)

- a. Define **Cost of Sales**. 1 mark
- b. Distinguish between the **cost of inventory sold** and the **cash paid for inventory**, stating the report in which each is reported. 3 marks

Question 7 (4 marks)

Sea Lake Cellars sells its *Vine* red (per bottle) and values it on a **FIFO** basis. The following relate to the *Vine* red for July 2026.

- **1 Jul** — opening balance: 12 bottles at \$9 each.
- **5 Jul** — purchased 18 bottles on credit at \$11 each (**Invoice 220**).
- **10 Jul** — the owner took 4 bottles for private use (**Memo 4**).
- **20 Jul** — used 3 bottles to cater a promotional tasting for the business (**Memo 8**).

- a. Complete the inventory card for the *Vine* red for July. 2 marks
- b. State the cost of the drawings and the cost of the inventory used for advertising, and name the account debited with each. 2 marks

Topic 3 Test B — solutions

Question 1 (7 marks)

a. The purchase return on 9 May removes 4 sets at the supplier-identified cost of \$32 (\$128), leaving 10 @ \$28 and 16 @ \$32 on hand. The sale of 18 sets on 17 May draws oldest-first — 10 @ \$28 (\$280) then 8 @ \$32 (\$256).

Inventory Card — Vortex brake pad set (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 May	Balance							10	28	280
4 May	Inv. 410	20	32	640				10	28	280
								20	32	640
9 May	CN 18 (purchase return)				4	32	128	10	28	280
								16	32	512
17 May	Inv. S52				10	28	280	8	32	256
					8	32	256			

b. Cost of Sales (17 May) = \$280 + \$256 = **\$536**.

c. Closing inventory at 31 May = 8 @ \$32 = **\$256**.

Question 2 (6 marks)

a. The sale of 7 pendants is identified as 2 @ \$120 (\$240) and 5 @ \$140 (\$700), leaving 2 @ \$120 and 3 @ \$140. The count of 4 against a recorded 5 is a loss of 1 pendant, identified as a \$140 pendant.

Inventory Card — Aurora pendant (Identified Cost)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Jun	Balance							4	120	480
6 Jun	Inv. 305	8	140	1120				4	120	480
								8	140	1120
15 Jun	Inv. S40				2	120	240	2	120	240
					5	140	700	3	140	420
30 Jun	Memo 7 (loss)				1	140	140	2	120	240
								2	140	280

b. Cost of Sales (15 June) = 2 @ \$120 + 5 @ \$140 = \$240 + \$700 = **\$940**.

c. The missing pendant is identified as a \$140 pendant, so the inventory loss = 1 @ \$140 = **\$140**. (Closing inventory = 2 @ \$120 + 2 @ \$140 = **\$520**.)

Question 3 (6 marks)

a. $\text{GST} = 1/11 \times \$5\,610 = \text{\$510}$, so Sales (the GST-exclusive amount) = $\$5\,610 - \$510 = \text{\$5\,100}$.

b. $\text{GST} = 1/11 \times \$3\,300 = \text{\$300}$, so Inventory (the GST-exclusive cost) = $\$3\,300 - \$300 = \text{\$3\,000}$.

c. The GST is recorded in the **GST Clearing** account. For a trading firm its balance is usually a **current liability** — the net GST collected on sales less the GST paid on purchases and expenses, owed to the Australian Taxation Office and payable within the next period. (It is occasionally a current asset, when a refund is due.)

Question 4 (7 marks)

a. Net Purchases = $\$92\,000 - \$4\,000 = \text{\$88\,000}$.

b. Cost of goods available for sale = opening inventory $\$14\,000$ + Net Purchases $\$88\,000 = \$102\,000$; Cost of Sales = $\$102\,000 - \text{closing inventory } \$18\,000 = \text{\$84\,000}$.

Boort Building Supplies — Cost of Sales	\$
Opening inventory	14 000
add Purchases	92 000
less Purchase Returns	(4 000)
Cost of goods available for sale	102 000
less Closing inventory	(18 000)
Cost of Sales	84 000

c. Net Sales = $\$150\,000 - \$6\,000 = \text{\$144\,000}$; Gross Profit = $\$144\,000 - \$84\,000 = \text{\$60\,000}$.

Question 5 (6 marks)

a. Here inventory fell for **two** reasons — sales **and** a loss — so “available – closing” captures both, and the loss must be separated out. Cost of goods available for sale = $\$9\,000 + \$61\,000 = \$70\,000$; available – closing = $\$70\,000 - \$11\,500 = \$58\,500$, which is Cost of Sales **plus** the $\$500$ loss. Therefore **Cost of Sales = $\$58\,500 - \$500 = \$58\,000$** .

b. Gross Profit = $\$96\,000 - \$58\,000 = \text{\$38\,000}$; Adjusted Gross Profit = $\$38\,000 - \500 (inventory loss) = **$\$37\,500$** .

c. Cost of Sales is only the cost of the inventory that was **sold**; the lost units were **not** sold, so their cost is reported separately as an **inventory loss** (deducted from Gross Profit), not included in Cost of Sales.

Question 6 (4 marks)

a. **Cost of Sales** is the total **cost price** of the inventory that was **sold** during the period — the cost the business gave up to earn its sales revenue (an expense in the Income Statement).

b. The **cost of inventory sold (Cost of Sales)** is the cost of the goods **sold** this period; it is an **expense**, deducted from Net Sales in the **Income Statement**, and is not a cash flow. The **cash paid for inventory** is the cash that actually left the Bank to **buy** inventory this period; it is an **operating outflow** in the **Cash Flow Statement**, and is not an expense — buying inventory swaps one asset (Bank) for another (Inventory). The two differ whenever the business buys a different quantity from the quantity it sells, the gap being the change in the level of inventory on hand.

Question 7 (4 marks)

a. Under FIFO the oldest units are assumed to leave first, so both the drawings (4 @ $\$9$) and the advertising use (3 @ $\$9$) are taken from the $\$9$ layer.

Inventory Card — Vine red (per bottle) (FIFO)

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
1 Jul	Balance							12	9	108
5 Jul	Inv. 220	18	11	198				12	9	108

Date	Details	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
								18	11	198
10 Jul	Memo 4 (drawings)				4	9	36	8	9	72
								18	11	198
20 Jul	Memo 8 (advertising)				3	9	27	5	9	45
								18	11	198

b. Drawings = 4 @ \$9 = **\$36**, debited to the **Drawings** account; inventory used for advertising = 3 @ \$9 = **\$27**, debited to the **Advertising** account. Neither carries GST, because no sale has taken place — only the cost of the inventory is transferred out. (Closing inventory = 5 @ \$9 + 18 @ \$11 = \$243.)